EUROPEAN CENTRAL BANK

EUROSYSTEM

Annual Report

2014

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Country abbreviations

BE	Belgium	**LU**	Luxembourg
BG	Bulgaria	**HU**	Hungary
CZ	Czech Republic	**MT**	Malta
DK	Denmark	**NL**	Netherlands
DE	Germany	**AT**	Austria
EE	Estonia	**PL**	Poland
IE	Ireland	**PT**	Portugal
GR	Greece	**RO**	Romania
ES	Spain	**SI**	Slovenia
FR	France	**SK**	Slovakia
HR	Croatia	**FI**	Finland
IT	Italy	**SE**	Sweden
CY	Cyprus	**UK**	United Kingdom
LV	Latvia	**JP**	Japan
LT	Lithuania	**US**	United States

In accordance with EU practice, the EU Member States are listed in this report using the alphabetical order of the country names in the national languages.

Foreword

The range of efforts in which the European Central Bank (ECB) was engaged in 2014 was, by any historical standard, extraordinary. It gives me great satisfaction to be able to report here how the ECB, its Executive Board, its staff and the Eurosystem committees responded to challenges and empowered the Governing Council to deliver on our mandate and our responsibilities.

In 2014 various strands of work initiated in previous years came together to produce a consistent policy response, one that allows us now to envisage with confidence that the weak and uneven recovery experienced in 2014 will turn into a more robust, sustainable upturn – and that inflation will return without undue delay to the ECB's objective of below, but close to, 2% over the medium term.

From a monetary policy perspective, the environment we faced in 2014 was complex. The muted recovery that had begun in 2013 did not accelerate as initially expected. Monetary growth remained subdued and credit continued to contract, albeit at a gradually slower pace. In a context of low domestic inflationary pressures, the considerable fall in oil prices from the middle of 2014 resulted in further significant falls in inflation towards the end of the year. A key concern in this environment was that inflation would remain low for too long a period of time, ultimately also affecting inflation expectations over the longer term.

This called for monetary policy to act forcefully. We had to deploy unconventional monetary policy measures for two broad reasons. First, the transmission of our monetary policy had for some time been impaired across the euro area, with wide differences between countries. And second, the scope for using the standard instrument of monetary policy – short-term nominal interest rates – was limited as those rates were already near the effective lower bound.

In June and September, that remaining margin was exhausted as the Governing Council lowered policy interest rates to the effective lower bound, and introduced a negative interest rate on the ECB's deposit facility. We also announced a series of targeted longer-term refinancing operations (TLTROs) with the intention of supporting bank lending to the real economy.

In September the Governing Council responded to a further worsening of the inflation outlook by announcing purchases of asset-backed securities and covered bonds, thereby initiating a monetary expansion by means of asset purchases, which was subsequently buttressed by the decision, announced in January 2015, to also purchase public sector securities.

Unusual challenges called for unusual responses. And this also applied to our communication. As the response of the economy to monetary policy impulses depends crucially on expectations, we had to make a greater effort to explain how we understood the new economic environment and to clarify our reaction function within it.

In this vein, alongside the strengthening of the forward guidance which we had introduced in 2013, we laid out clearly in April the contingencies that would – and eventually did – prompt the Governing Council to take action. The monetary policy measures taken through the year were fully consistent with the road map laid out then. They confirmed the unanimous commitment signalled by the Governing Council to use both conventional and unconventional instruments to deal effectively with the risk of a too prolonged period of low inflation.

Our focus on continuously enhancing the transparency of our deliberations and actions culminated in the announcement of our intention to start publishing accounts of the monetary policy discussion during Governing Council meetings. This began for the first meeting of 2015.

Monetary policy does not, however, operate in a vacuum, and it benefited from another major undertaking by the ECB in 2014: the preparations for and start of operations of the Single Supervisory Mechanism (SSM). This extraordinary achievement, which involved hiring hundreds of new staff over a short period of time, provided the opportunity to conduct the largest-ever review of the quality of bank assets.

The year-long comprehensive assessment of the balance sheets of the euro area's 130 biggest banks, which was completed in 2014, increased transparency and prompted many institutions to take pre-emptive action to strengthen their balance sheets, including via asset sales and capital raising. This in turn helped to put the banking system in a better position to transmit monetary policy impulses, and more generally to support the recovery by performing more normally its function of efficient credit allocation in the real economy.

Early evidence shows that our parallel policy initiatives, when combined, were effective. Bank lending rates to non-financial corporations started to decline in the second half of the year, and showed less dispersion across countries. The contraction of credit appears to be reversing. Growth projections, as well as inflation expectations – reflected both by outside observers and by ECB staff projections – have been revised upwards. And confidence overall has increased.

Our actions have therefore not only been consistent with our mandate. They have been credible, transparent and effective. They are continuing to underpin confidence in the euro, a currency whose attractiveness was confirmed at both ends of 2014: at the start, when Latvia became the 18th member country of the euro area; and at the end, as we were finalising preparations for the accession of Lithuania on 1 January 2015, bringing the number of states in the union to 19, representing 338 million people.

One further major project that was successfully completed in 2014 merits a mention here. The latest addition to the Frankfurt skyline took its final shape. The cranes came down, the internal fit-out was completed, and the ECB staff assigned to work in our new headquarters building moved into new office space on the banks of the river Main.

This annual report goes into much richer detail on all these topics, describing our tasks and activities through 2014 and painting the wider macroeconomic picture. Compared with previous years, we have streamlined and enhanced the content in order to give you the best possible overview. While the coming year will bring with it fresh challenges, I speak on behalf of all ECB staff when I say we remain single-minded in our commitment to deliver price stability for all euro area citizens.

Frankfurt am Main, April 2015

Mario Draghi
President

Chapter 1
The euro area economy, the ECB's monetary policy and the European financial sector in 2014

1 The euro area economy: low inflation and a weak recovery

1.1 The global macroeconomic environment

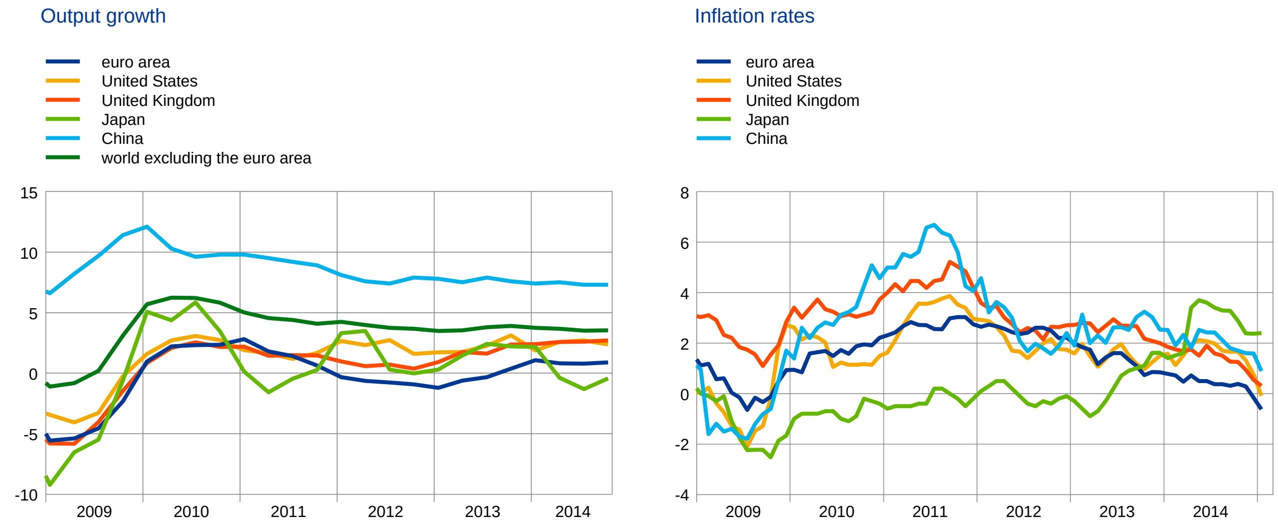
Three key developments in the world economy had a particularly significant influence on the euro area economy in the course of 2014: uneven growth developments across different regions of the world as well as continued weakness in global trade; falling oil and other commodity prices; and a weaker euro exchange rate.

The global economic recovery remained gradual and uneven

The world economy expanded moderately in 2014, amid widening divergence across and within regions. Weakness in the first half of the year was largely due to temporary and one-off factors, such as the unusually cold winter in the United States and the shutdown of heavy-industry plants in China for environmental reasons. As the

Chart 1
Main developments in selected economies

(annual percentage changes; quarterly data; monthly data)



Sources: Eurostat and national data.
Notes: GDP figures are seasonally adjusted. HICP for the euro area and for the United Kingdom; CPI for the United States, China and Japan.

year progressed, world activity gradually strengthened, setting the scene for more favourable, yet modest, external demand conditions for the euro area (see Chart 1).

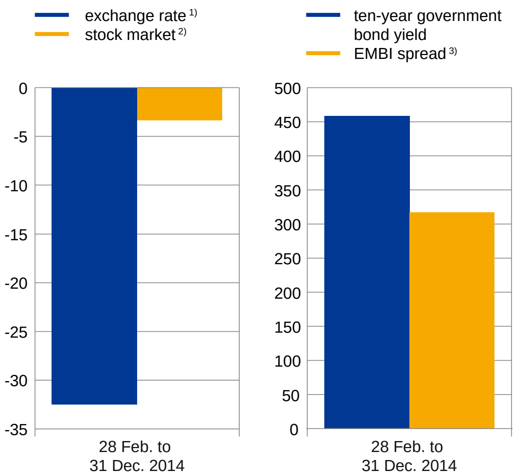
The shift in growth dynamics across regions that had already started in late 2013 continued in 2014, with momentum firming in most major advanced economies, while losing vigour in emerging market economies. Advanced economies increasingly benefited from waning private sector deleveraging, improved labour markets, rising confidence and accommodative policies. By contrast, in several emerging market economies, structural impediments and tightened financial conditions persisted, weighing on their growth prospects. Geopolitical risks, relating mostly to the conflict between Ukraine and Russia and tensions in major oil-producing countries, persisted throughout the year, but their direct impact on global activity remained rather limited (see also Box 1).

Box 1
The Ukraine conflict and its economic implications for the euro area

As the conflict in eastern Ukraine escalated in the course of 2014, the sanctions imposed on Russia were progressively tightened. Most notably, the EU imposed financial market access restrictions on Russian banks and corporations in August, in close cooperation with the United States and other OECD countries. These measures were expanded in September to encompass a wider set of companies and financial instruments. In addition, the sale of defence equipment and the export of technologies to explore deposits of arctic, deep water and shale oil were prohibited. In retaliation, Russia introduced an embargo on food imports from the EU, the United States, Australia, Canada and Norway in August.

Chart A
Financial market developments in Russia

(percentage changes; differences in basis points)



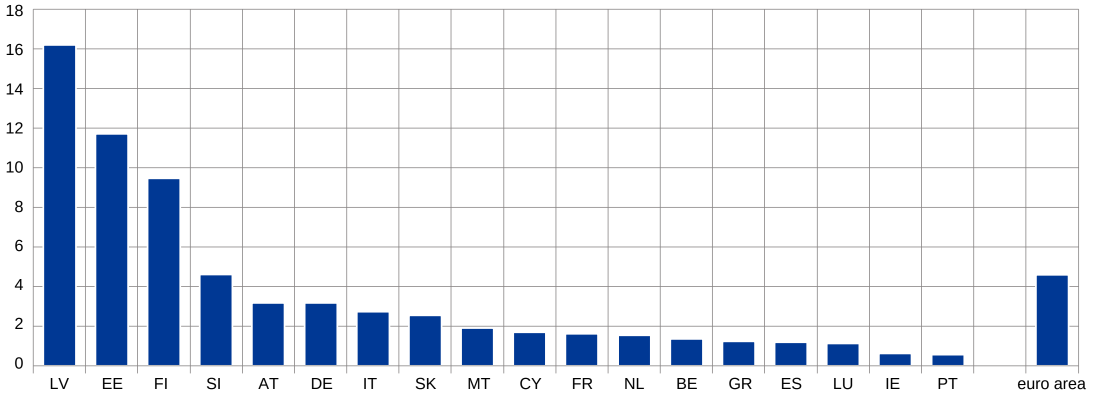
Sources: JPMorgan, Bank of Russia, MICEX and Haver Analytics.
1) Russian rouble exchange rate against the Bank of Russia's 55% USD/45% EUR basket.
2) Stock market index denominated in roubles.
3) JPMorgan Emerging Market Bond Index spread of USD-denominated Russian sovereign bonds.

In combination with the considerable uncertainty triggered by the crisis and the fall in energy prices, the sanctions have placed a heavy burden on Russia's economy. Already facing a protracted period of comparatively sluggish growth owing to widespread structural rigidities, economic activity was further dampened by the fallout from developments in Ukraine, mainly via two interrelated channels. First, funding costs for Russian banks, corporations and the government have soared (see Chart A), negatively affecting their financing options and therefore investment. Second, inflationary pressures have intensified, partly owing to the rouble's steep depreciation, but also reflecting the adverse effects on domestic food prices from Russia's embargo on imports of agricultural goods. This has eroded real incomes and forced the Bank of Russia to tighten liquidity conditions by means of foreign

Chart B

Euro area merchandise exports to Russia

(as a percentage of total merchandise exports)



Sources: IMF and ECB calculations.
Notes: Data as at 2013. For the euro area, the figures are net of intra-euro area merchandise exports.

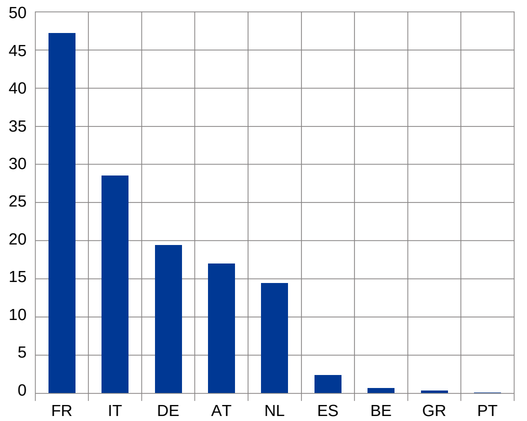
exchange interventions and interest rate hikes, with adverse consequences for private consumption and investment. Taken together, these factors caused the Russian economy to stagnate in 2014.

For the euro area, the impact of the crisis on growth and inflation seems to have been fairly moderate in 2014, notwithstanding notable trade links with Russia. Net of intra-euro area trade, Russia accounted for close to 5% of euro area merchandise exports, although exposure varies across individual euro area countries (see Chart B). Euro area exports to Russia primarily take the form of investment and consumer goods, whereas oil and gas constitute the euro area's main imports from Russia. In 2014 exports to Russia fell tangibly for most euro area countries. However, it is difficult to disentangle the possible effects of the conflict in Ukraine, the associated sanctions and Russia's food embargo from the lack of demand owing to the overall weakness of Russia's economy. Similarly, indicators of consumer and business confidence deteriorated in some euro area countries after March 2014, but it is difficult to attribute such changes solely to events in Ukraine since other domestic or global factors may also have played a role. Finally, prices in the euro area in 2014 appeared to be little affected by the repercussions of the conflict.

Chart C

Claims of euro area banks against Russia

(USD billions)



Source: BIS.
Notes: Data as at the third quarter of 2014 (the third quarter of 2012 for Austria). Not all euro area countries report their cross-border bank claims to the BIS.

Just as the trade effects have been moderate, the Ukraine conflict has had limited financial implications for banks in the euro area. Nonetheless, claims on Russia by banks in some euro area countries are sizeable. In absolute terms, in the third quarter of 2014 the cross-border claims against Russia of banks headquartered in France amounted to USD 47 billion, followed by institutions in Italy (USD 29 billion), Germany (USD 19 billion), Austria (USD 17 billion) and the Netherlands

(USD 14 billion) (see Chart C). However, these exposures are unlikely to constitute a systemic risk for the euro area as a whole. This said, potential spillovers from events in Russia may heterogeneously affect individual euro area countries and banking groups.

Meanwhile, financial market volatility and risk aversion overall remained low during most of the year. However, two short-lived episodes of financial market turmoil occurred in early 2014 and in October 2014, when concerns about the resilience and pace of the global recovery emerged. Moreover, the US Federal Open Market Committee's tapering of its asset purchases contributed to a gradual reduction in global liquidity from January 2014 onwards, further adding to financial market volatility at the beginning of 2014. The financial market tensions mostly affected those emerging market economies with significant domestic and external imbalances, having only very limited spillover effects on the euro area and the global economy.

World trade remained weak overall in 2014. Following several months of anaemic readings in the first half of the year, short-term trade indicators rebounded strongly in the second half of the year, albeit from very low levels. Overall, the volume of world imports of goods grew by 3.5% year on year in 2014, compared with 2.6% in 2013 (according to data from the CPB Netherlands Bureau of Economic Policy Analysis). As in the case of global activity, the sources of the underlying weakness in global trade shifted gradually from advanced economies to emerging market economies. The muted response of global trade to the gradual global recovery can be partly attributed to structural factors, such as the declining support from expanding global value chains. In addition, investment, which is typically a highly trade-intensive demand component, grew at an unusually subdued pace in a number of major economies.

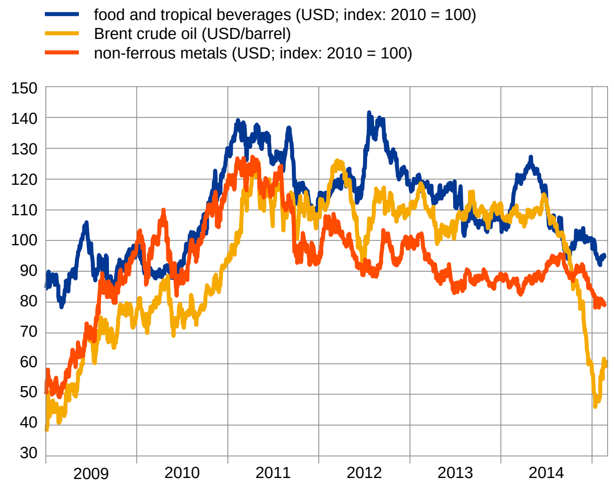
Falling oil prices put downward pressure on global inflation

Turning to price developments, the main driving force behind subdued global inflation in 2014 was falling commodity prices, namely energy and, to a much lesser extent, food prices. The steady rise of global inflation until June was succeeded by a gradual slowdown in most advanced and emerging market economies, largely reflecting the sharp decline in international oil prices in the second half of the year. In the OECD area, average headline consumer price inflation edged up to 1.7% in 2014, from 1.6% in 2013, while average OECD consumer price inflation excluding food and energy increased to 1.8% from 1.6%.

In the course of 2014 oil prices declined by 49% in US dollar terms and 41% in euro terms, as oil prices plunged from late June onwards. Following a period of relative stability at around USD 110 per barrel in the first half of 2014, Brent crude oil prices reached levels below USD 60 per barrel by the end of the year (see Chart 2). Robust oil supply and weaker than expected oil demand explained the sharp decline in oil prices in the second half of the year. On the supply side, OPEC production increased as countries affected by geopolitical tensions, such as Libya and Iraq, provided surprisingly high oil output, which added to robust non-OPEC supply growth driven

Chart 2
Commodity prices

(daily data)



Sources: Bloomberg and Hamburg Institute of International Economics.

by unconventional oil production in North America (shale and tar sands). Moreover, within this context, OPEC decided at the end of November to leave its production target unchanged. At the same time, oil demand was weak, reflecting modest global growth.

Non-energy commodity prices (denominated in US dollars) declined by about 12% compared with the beginning of the year. Food prices were mainly driven by developments in cereal prices. Following a sharp increase between February and May, cereal prices strongly declined on account of a record global harvest (in the United States and Europe in particular). Contrary to expectations related to the conflict situation in Ukraine, Black Sea grain production did not suffer significant disruptions. On aggregate, metal prices decreased as price increases for aluminium, nickel and zinc on the back of tightening supply were more than offset by a strong decline in the price of iron ore.

In addition to weaker international energy and food prices, inflationary pressures have been contained by the rather moderate global recovery. Growth in 2014 was characterised by the very slow absorption of global spare capacity and labour market slack. At a country level, consumer price inflation was also affected by other factors, including exchange rate developments. For example, the appreciation of the US dollar and the pound sterling amplified the downward effect of falling international commodity prices on inflation in the United States and the United Kingdom respectively.

Uneven growth momentum in major economies

In the United States, economic activity accelerated in 2014, with real GDP growth at 2.4% on average, 0.2 percentage point higher than in the previous year. Expectations at the beginning of the year had been higher: in January 2014 the average Consensus Economics forecast for annual GDP growth stood at 2.8%. One factor behind the eventual growth outturn was the adverse weather conditions at the turn of the year, which led to a significant decline in economic activity in the first quarter of 2014. In the remainder of the year economic growth was fairly strong and supported by final domestic demand, suggesting that the recovery became more sustainable. This development was consistent with the gradually improving economic fundamentals supported by accommodative monetary policy, buoyant financial market conditions, positive wealth effects from rising stock and house prices, and improvements in the housing and labour markets.

Inflation remained relatively subdued in 2014 as a whole. This was mainly due to spare capacity in the economy, together with sharp declines in energy prices and an appreciation of the US dollar in nominal effective terms in the second half of the year. Average annual CPI inflation stood at 1.6% in 2014 after 1.5% in 2013. Inflation excluding food and energy prices was 1.7% in 2014, following 1.8% in 2013.

Monetary policy stayed accommodative in 2014. In the context of generally improving economic prospects, the US Federal Open Market Committee (FOMC) gradually reduced its asset purchases over the course of the year and concluded them in October. In addition, the FOMC kept its target for the federal funds rate unchanged within a range of 0% to 0.25% throughout 2014. The threshold-based guidance based on the unemployment rate and projected inflation rate, provided by the FOMC since December 2012, was changed in March 2014 as the actual unemployment rate approached the threshold of 6.5%. The FOMC moved to a qualitative form of guidance, taking into account a wide range of variables in determining how long to maintain its federal funds rate target range. As regards fiscal policy, the federal fiscal deficit declined to 2.8% of GDP in the fiscal year 2014, down from 4.1% in the fiscal year 2013 and the lowest since 2007.

In Japan, economic activity slowed markedly during most of 2014. Headline inflation rose during 2014 following the consumption tax increase. However, underlying price pressures remained subdued, with consumer price inflation excluding the consumption tax increase well below the Bank of Japan's 2% inflation target. The Bank of Japan expanded its quantitative and qualitative monetary easing programme by accelerating the annual pace of increase in the monetary base to about JPY 80 trillion (from about JPY 60-70 trillion previously) and made it open-ended, following downward pressure on prices and weak growth.

In the United Kingdom, the pace of economic activity remained robust in the course of 2014. The decline in macroeconomic uncertainty and relatively loose credit conditions supported domestic demand, in particular private consumption and housing investment, leading to an acceleration in GDP growth from 1.7% in 2013 to 2.6% in 2014, according to preliminary estimates. Stronger growth was accompanied by a strengthening of the labour market. The unemployment rate declined to 5.7% at the end of 2014, compared with a level of more than 7% one year before. Despite the recovery in GDP growth, government borrowing in the first half of the fiscal year 2014-15 exceeded initial budget forecasts, owing in large part to weak earnings growth, and the government budget deficit stood above 5% of GDP.

Inflation declined below the Bank of England's target of 2%. Inflation averaged 1.5% in 2014, mainly owing to moderate wage growth and the lagged effects of the appreciation of the pound sterling in the first half of the year. Throughout the year the Bank of England's Monetary Policy Committee maintained an accommodative monetary policy stance, keeping the policy rate at 0.5% and the size of the asset purchase programme at GBP 375 billion.

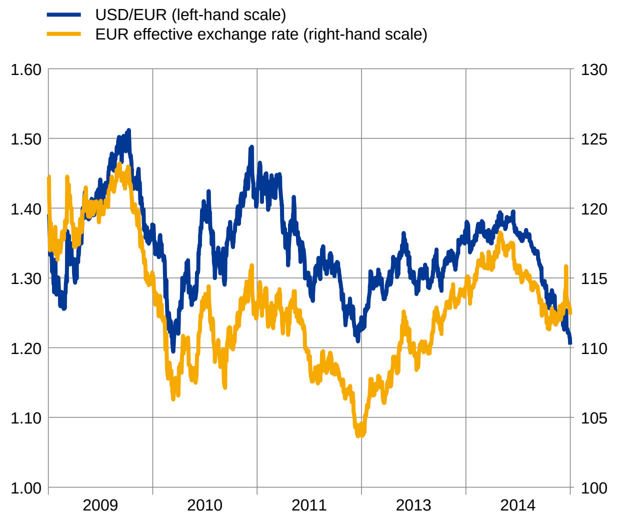
In China, real GDP growth continued to decline, owing to slower investment growth, in particular for residential investment. Exports were relatively robust on the back of a recovering external environment, while import growth remained lacklustre in line with weakening investment and lower oil prices, leading to a slight increase in the current account surplus to 2.1% of GDP. The authorities started implementing a considerable number of structural reforms, making progress in opening up the capital account and interest rate liberalisation, among other things. Credit expansion continued to be strong, while there were increasing signs of financial stress as the economy weakened. Inflationary pressures remained subdued owing to lower commodity prices, but also because of continued restructuring in construction-related industries. Notably, producer price inflation remained negative for another year. The appreciation of the renminbi slowed down markedly in 2014.

The euro weakened

In the course of 2014 the euro weakened in nominal effective terms. Euro exchange rate developments in 2014 largely reflected the different cyclical positions and monetary policy stances across major economies. In early May 2014 the euro peaked at levels similar to those in 2010-11 both in nominal effective terms and vis-à-vis the US dollar, after undergoing a period of steady appreciation that had started in July 2012 (see Chart 3). From June 2014 onwards the euro depreciated in particular against the US dollar against the background of a continuously declining outlook for growth and inflation in the euro area, while the ECB announced additional monetary policy measures. In the last two months of the year the depreciation of the euro's effective exchange rate was partly reversed by the pronounced weakness of the Japanese yen and the Russian rouble.

Chart 3
Euro exchange rate

(daily data)



Source: ECB.
Note: Nominal effective exchange rate against 39 major trading partners.

The nominal effective exchange rate of the euro (as measured against 39 major trading partners) declined by 3.4% in annual terms. Bilaterally, the euro weakened most strongly against the US dollar (-12.6%), as the US Federal Reserve System continued to taper and eventually ceased asset purchases under its quantitative easing programme in an environment of steady domestic growth and improving labour market developments. In line with this, the euro weakened against currencies that are linked to the US dollar, including the Chinese renminbi (-10.2%). The euro also depreciated against the pound sterling (-6.8%). By contrast, the euro appreciated slightly against the Japanese yen (+0.4%). The appreciation largely occurred after the Bank of Japan announced that it would extend its unsterilised government bond purchases and use further non-standard monetary policy measures to achieve its medium-term inflation target. Finally, the euro appreciated strongly against the Russian rouble (+60%), in particular after the Bank of Russia officially adopted a floating exchange rate regime in November in an environment of persisting geopolitical tensions and declining energy prices.

Turning to those European currencies that have close links to the euro, the Danish krone is currently the only currency in the European exchange rate mechanism II (ERM II), after Latvia and Lithuania joined the euro area on 1 January 2014 and 1 January 2015 respectively.[1] The Bulgarian lev remained fixed to the euro and the Swiss franc continued to trade within a narrow range close to its official cap of CHF/EUR 1.20 until the Swiss National Bank decided to abandon its currency ceiling vis-à-vis the euro on 15 January 2015. Finally, the euro strengthened against the currencies of those EU Member States with floating exchange rate regimes. In particular, the euro appreciated against the Hungarian forint (+7.0%), the Swedish krona (+5.9%) and the Polish zloty (+2.8%), while it remained broadly stable against the Czech koruna (+1.1%), the Croatian kuna (+0.4%) and the Romanian leu (+0.3%).

1.2 Financial developments

The following key developments in the financial dynamics of the euro area stood out in 2014: the further normalisation of the situation in money markets, a significant decline in government bond yields and in intra-euro area sovereign spreads in most countries, a stabilisation in the cost of external financing for non-financial corporations and an improvement in the financial condition of households.

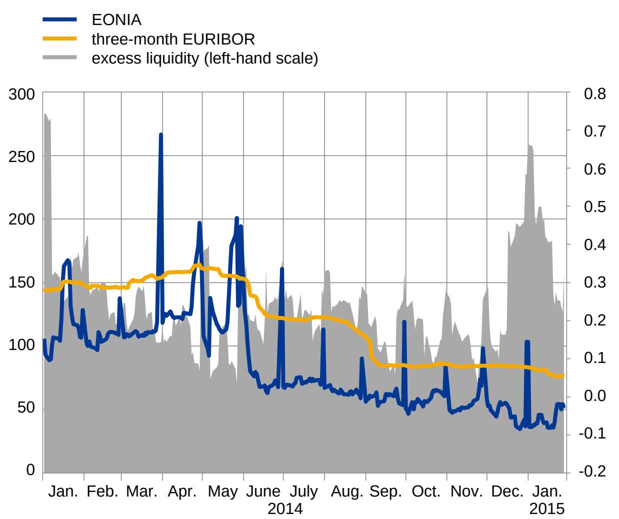
Conditions in the euro area money market continued to normalise

Trading activity in the euro area money market continued to improve over 2014, although some fragmentation along national lines remained. The decisions of the ECB's Governing Council to lower the main refinancing rate to close to zero and move the deposit facility rate into negative territory (see Section 2.1) implied that short-term money market rates became negative. For instance, in December 2014 overnight index swap rates were negative for maturities of up to three years, and at longer maturities the yield curve flattened.

Chart 4

Short-term money market rates and excess liquidity

(EUR billions; percentages per annum)



Sources: ECB and Bloomberg.

During the first half of 2014 short-term money market rates were characterised by slightly higher volatility, which, however, did not translate into an increase in either the level or the volatility of longer-term money market rates. In May the volatility observed in short-term rates was notably linked to the fluctuations in excess liquidity as counterparties adapted their recourse to Eurosystem operations against the background of high three-year longer-term refinancing operation (LTRO) repayments, as well as high volatility in autonomous factors (see Chart 4).

While the introduction of the negative deposit facility rate in June 2014 was overly reflected in overnight money market rates, the subsequent rate cut by

[1] The Danish krone traded slightly above its target rate of DKK/EUR 7.460 at the end of 2014, while the Lithuanian litas traded at a fixed peg before the country adopted the euro.

another 10 basis points to -0.20% was not fully passed on. Overall, however, this left overnight rates only slightly negative after the September rate cut, and they thus remained significantly above the deposit facility rate, also when the modest level of excess liquidity is taken into account.

Several factors appear to explain the lagged pass-through. First, as expected, many banks were reluctant to pass on the negative deposit facility rate to parts of their deposit base. Second, as regards their own holdings, banks employed generic negative rate avoidance strategies, such as an intensified search for yield at longer-term maturities. Third, a number of other frictions accounted for the lagged pass-through in specific areas of the market.

Despite this lagged pass-through in very short-term money market rates, negative rates resulted in lower funding costs further along the curve, given the shift in investor preferences towards longer maturities.

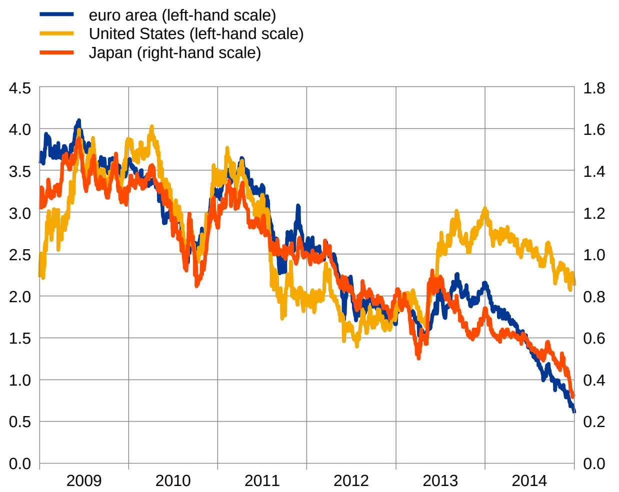
Government bond yields declined significantly

Most euro area government bond yields declined significantly and reached new historical lows. During 2014 long-term yields on AAA-rated sovereign bonds in the euro area experienced significant declines (see Chart 5). This was a result of increasing concerns among investors about macroeconomic prospects, the likelihood of lower inflation, and the forward guidance and other monetary policy decisions of the ECB. Additionally, the very low money market rates triggered a search for yield. As the US Federal Reserve System began to phase out its quantitative easing programme, the long-term bond yield spread between the United States and the euro area widened to its highest level since 2004.

Chart 5

Long-term government bond yields

(percentages per annum; daily data)



Sources: EuroMTS, ECB, Bloomberg and Thomson Reuters.
Notes: Long-term government bond yields refer to ten-year bonds or to the closest available bond maturity. The euro area government bond yield is based on the ECB's data on AAA-rated bonds, which include bonds from Austria, Finland, Germany and the Netherlands.

Intra-euro area sovereign spreads declined further for most countries, notably for those which experienced more significant improvements in macroeconomic and fiscal fundamentals. Credit spreads also narrowed in the corporate bond market, despite a few episodes of volatility owing to geopolitical tensions and valuation concerns.

Financial market indicators of inflation expectations declined in 2014, particularly at short to medium-term horizons. Longer-term inflation expectations also declined below 2% in the latter part of the year.

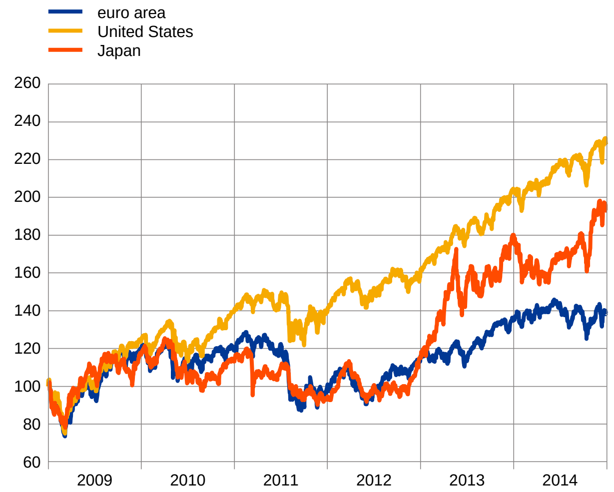
Performance of euro area equity markets was mixed

Euro area equity markets rose steadily in the first half of 2014, but then showed a more mixed performance, contrasting with developments in the United States and

Chart 6

Major stock market indices

(index: 1 January 2009 = 100; daily data)

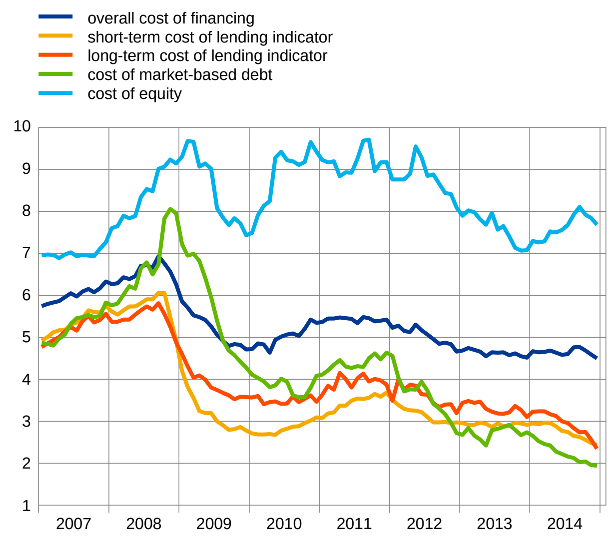


Source: Thomson Reuters.
Note: The indices used are the Dow Jones EURO STOXX broad index for the euro area, the Standard & Poor's 500 index for the United States, and the Nikkei 225 index for Japan.

Chart 7

Overall nominal cost of external financing for non-financial corporations in the euro area

(percentages per annum; three-month moving averages)



Sources: ECB, Merrill Lynch, Thomson Reuters and ECB calculations.
Notes: The overall cost of financing for non-financial corporations is calculated as a weighted average of the cost of bank lending, the cost of market-based debt and the cost of equity, based on their respective amounts outstanding derived from the euro area accounts. The cost of equity is measured by a three-stage dividend discount model using information from the Datastream non-financial stock market index. The latest observations are for December 2014.

in Japan (see Chart 6). In the second half of the year rising geopolitical tensions and concerns about the global growth outlook weighed on stock markets. The downward pressures on euro area stocks were stronger than those in other major markets, reflecting weaker than expected economic data releases for the euro area and the fact that geopolitical tensions weighed more heavily on euro area stocks as the macro-financial consequences of the Russia/Ukraine conflict were considered more severe for the euro area. Overall, although the recovery in euro area stock markets has been considerable in recent years, the EURO STOXX index still remains around 25% below its level at end-2007.

Cost of external financing for non-financial corporations stabilised

The overall nominal cost of external financing for non-financial corporations was broadly unchanged. A marked decrease in the cost of market-based debt and in the cost of bank lending was almost fully compensated for by a significant increase in the cost of equity, which in turn was explained by a surge in equity risk premia in the first nine months of the year (see Chart 7). At the same time, although moderating somewhat, the heterogeneity in external financing costs across euro area countries remained significant.

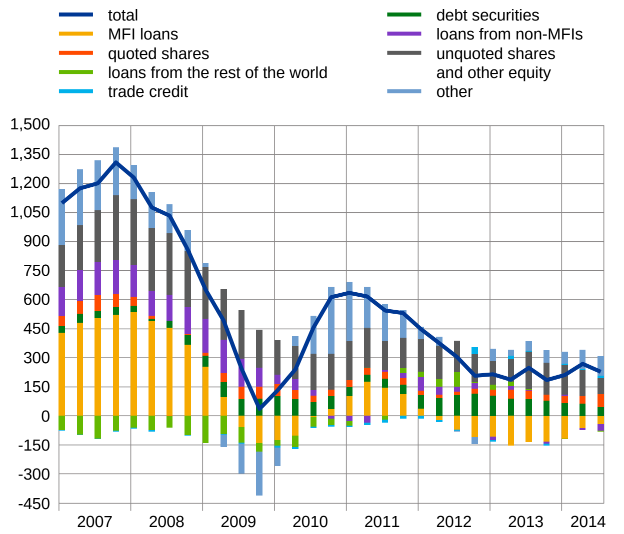
Recourse to external financing was broadly stable at low levels

In 2014 non-financial corporations' use of external financing was broadly stable at low levels (see Chart 8), after moderating between early 2011 and mid-2013. The net issuance of debt securities and quoted shares by non-financial corporations remained at robust levels and continued to more than offset the negative flows from the net redemptions of bank loans. Lending by non-MFIs and foreign entities was weak. This suggests that indirect bond issuance by non-financial corporations via their conduits resident in other member countries and outside the euro area was muted. Trade credit and inter-company lending remained weak, possibly as a result of firms using higher retained profits and deposit holdings to finance working capital. The net issuance of unquoted

Chart 8

Changes in the sources of external financing of non-financial corporations in the euro area

(four-quarter sums; EUR billions)

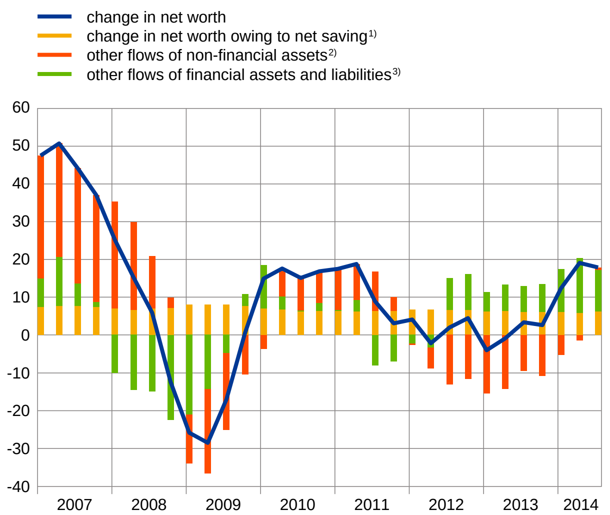


Sources: Eurostat and ECB.
Notes: MFI loans and loans from non-MFIs (other financial intermediaries, insurance corporations and pension funds) corrected for loan sales and securitisations. "Other" is the difference between the total and the instruments included in the chart. It includes inter-company loans. The latest observation is for the third quarter of 2014.

Chart 9

Change in the net worth of households

(four-quarter sums; percentages of gross disposable income)



Sources: Eurostat and ECB.
Notes: Data on non-financial assets are estimates by the ECB. The latest observation is for the third quarter of 2014.
1) This item comprises net saving, net capital transfers received and the discrepancy between the non-financial and the financial accounts.
2) Mainly holding gains and losses on real estate (including land).
3) Mainly holding gains and losses on shares and other equity.

shares and other equity moderated.[2] Non-financial corporations' indebtedness (measured as a percentage of GDP) stabilised at high levels, after having declined continuously since mid-2012. Continued deleveraging may have been prevented by the weakness in economic activity.

Household net worth continued to rebound

In 2014 households' net worth continued to rebound, on account of continued increases in securities prices, while losses on real estate holdings decreased markedly (see Chart 9). Households' financial investment, although having slightly increased, remained at levels close to its historical low, reflecting still weak income growth and deleveraging needs in a number of countries. Households continued to allocate savings to deposits, as well as to life insurance and pension products. At the same time, they increased their mutual fund share and direct equity holdings significantly and continued to move away from debt securities. The financing costs of households declined markedly, but continued to vary depending on the type and maturity of the loan and the country of origin. Households' new borrowing from banks remained weak and their indebtedness continued to decline gradually, albeit remaining at relatively high levels. Households' debt ratios continued to differ significantly across countries. The household debt servicing burden declined further owing to the ongoing weakness in credit dynamics and declines in bank lending rates.

[2] This was partly due to foreign multinational firms continuing to transfer retained profits out of the euro area. Such transfers are initially recorded, by statistical convention, under this item in firms' balance sheets.

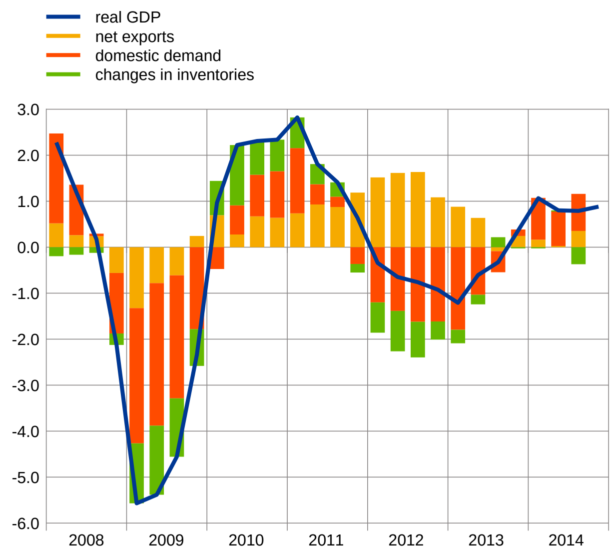
1.3 Economic activity

Following two years of negative annual real output growth in the wake of the sovereign debt crisis, in 2014 the gradual recovery in the euro area that had started in the second quarter of 2013 continued, albeit unevenly throughout the year. As a result, average annual growth stood at 0.9% in 2014. This outcome reflected a positive and increasing contribution from domestic demand, given broadly neutral contributions from net trade and inventory developments (see Chart 10). At the same time, the acceleration in growth that had been expected to take place around the middle of the year did not materialise. This reflected weak external demand and a variety of factors across euro area countries, with insufficient progress in the implementation of structural reforms in some countries playing a key role.

Chart 10

Euro area real GDP

(year-on-year percentage changes; year-on-year percentage point contributions)



Sources: Eurostat and ECB calculations.
Notes: Data up to the third quarter of 2014 are neither seasonally nor working day-adjusted. GDP growth for the fourth quarter of 2014 is estimated using the flash estimate, which is seasonally and working day-adjusted.

The economic recovery continued in 2014 but at a slow pace

The return to positive average annual growth in 2014 was supported by the very accommodative monetary policy stance, improving financing conditions and sounder fiscal balances. These factors, in particular the various monetary policy measures implemented over recent years, supported primarily consumer confidence and private consumption, which was the main driver of the recovery. Business confidence also improved relative to the average in 2013, as financial market uncertainty declined and financial conditions, including those for small and medium-sized enterprises, improved, notably during the first half of the year. Later in 2014 the decrease in energy prices brought a significant recovery – after an extended period of decline – in real disposable incomes among firms as well as households, where the latter also benefited from the rise in employment.

The growth trend in 2014 was at the same time dampened by a number of factors, mainly affecting investment. These factors related in particular to weak trade momentum, the high level of unemployment, the sizeable unutilised capacity, the ongoing adjustments of balance sheets in the public as well as the private sector and, not least, the insufficient impetus in, and uncertainties surrounding, the implementation of structural reforms in some euro area countries. A further dampening factor was related to geopolitical tensions, in particular in the context of the crisis in Ukraine, which implied higher uncertainty as regards economic prospects and profitability in the latter part of 2014.

A number of factors weigh on long-term growth. Box 2 reviews long-term potential output growth prospects in the euro area and the factors behind them and stresses the substantial benefits that can be reaped from further structural reforms.

Domestic demand contributed around 0.8 percentage point to output growth in 2014, the highest contribution since 2007. Private consumption continued to strengthen throughout 2014, after starting its recovery in 2013, on the back of the rise in real disposable income, supported by the decline in commodity prices. The household saving ratio broadly stabilised in the first half of 2014 and is expected to have remained at a relatively low level in the second half of the year, thus supporting consumption dynamics. Following declines in the previous two years, total investment rose overall in 2014, but contracted in the second and third quarters of the year, chiefly due to the persistent weakness in the construction component. This loss of momentum followed four consecutive quarters of positive quarterly growth and mainly reflects that the acceleration in growth that had been expected to take place around the middle of the year did not materialise. This held back investment as profits weakened and uncertainty regarding future demand prospects increased. Government consumption contributed positively to economic growth in 2014 mainly on account of slightly higher growth in social transfers in kind, which encompass items such as healthcare expenditure, whereas growth in compensation of public employees as well as intermediate consumption remained subdued or even slowed down.

Box 2

Long-term growth prospects for the euro area

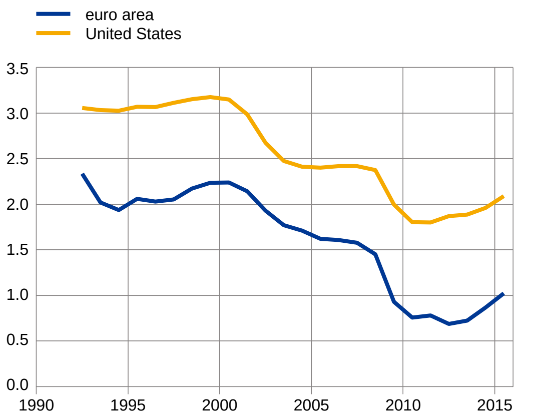
Potential output measures the level of economic activity that may be achieved in the medium to long term, when all resources are fully utilised. Estimates of potential output by international and European institutions, such as the European Commission, the IMF and the OECD, all show that the potential growth of the euro area has been negatively affected by the economic and financial crisis. It is estimated to have slowed to between 0.5% and 1.0% by 2014, from above 1.5% before the crisis. Looking ahead, longer-term projections indicate that potential growth in the euro area will gradually increase to pre-crisis growth rates, albeit remaining weaker than in the United States. This box reviews long-term growth prospects in the euro area and the underlying factors behind them.

What are the reasons for past differences with the United States?

Chart A

Potential growth estimates for the euro area and the United States

(annual percentage changes)



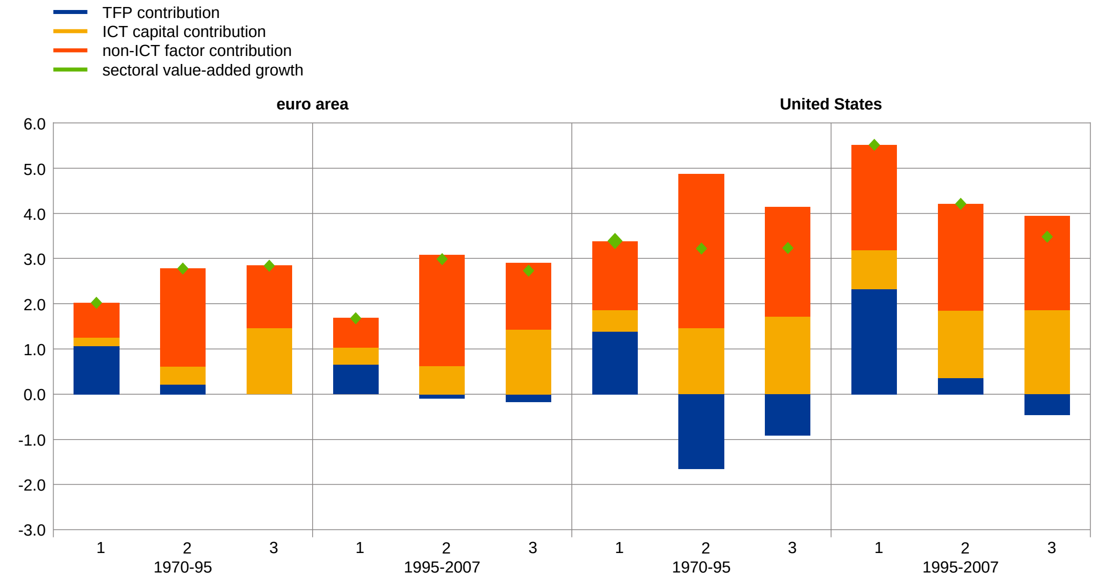
Source: OECD.

Euro area potential growth in the early 1990s is estimated to have been around 2%, considerably higher than estimates for the 2010s. In addition, potential growth in the euro area has been lagging behind that in the United States for several decades (see Chart A). Of the three main components of growth, namely labour, capital and total factor productivity (TFP), the growth of the latter in particular has been slower for the total economy in the euro area than in the United States (for a comparison of the determinants of potential growth in the euro area and the United States, see Chapter 5 of “Potential output from a euro area perspective”, *Occasional Paper Series*, No 156, ECB, November 2014). Several reasons might be behind this. A number of indicators on

Chart B

Sources of market services growth

(annual percentage changes; percentage point contributions)



Sources: EU KLEMS database and ECB calculations.
Notes: TFP stands for total factor productivity; ICT stands for information and communication technology. 1, 2 and 3 refer to distribution, financial and personal respectively.

research and development – such as the number of patents, the number of researchers as a share of the population, internet penetration and high-tech exports as a share of manufactured exports – suggest that the euro area is lagging behind in terms of innovative capacity. In particular, diffusion of information and communication technology (ICT) has played a larger role in the United States and its contribution to the productivity growth of the services sector has been higher (see Chart B). Although in the 2000s progress was made on product market reforms in the euro area, services and labour markets have remained more rigid than in the United States.

The effects of the economic and financial crisis

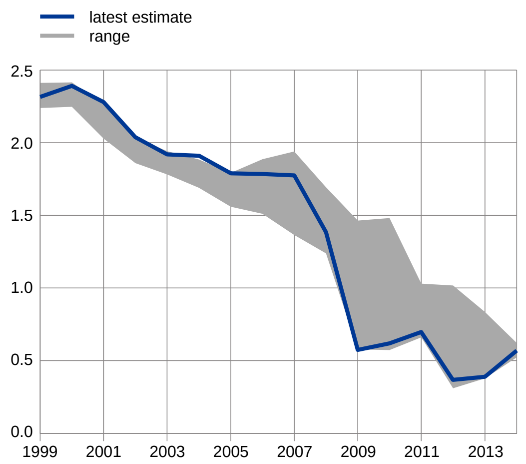
The economic and financial crisis has reduced euro area potential output via two main channels: lower investment and higher structural unemployment. First, during the most severe phase of the crisis, investment rates declined considerably, with financing conditions, such as terms and availability of credit, worsening in particular. Increased economic and political uncertainty and an unfavourable economic outlook made it more difficult to assess investment projects and lowered the expected rate of return on investments. High indebtedness of non-financial corporations in some euro area countries also made deleveraging necessary, further reducing credit demand.

Second, the crisis has also led to an increase in short to medium-term structural unemployment rates, indicated by the rise in long-term unemployment and an increase in skill mismatches. The unemployment rate of low-skilled workers has increased more than that of high-skilled workers, largely because the crisis triggered a sectoral relocation in many euro area economies, in particular a shift away from the construction sector. As it may be difficult for low-skilled workers dismissed from one sector to find jobs in other sectors, and as their human capital progressively erodes with the duration of unemployment, structural unemployment rates may remain elevated for an extended period.

Chart C

Range of potential output estimates made since 2008

(annual percentage changes)

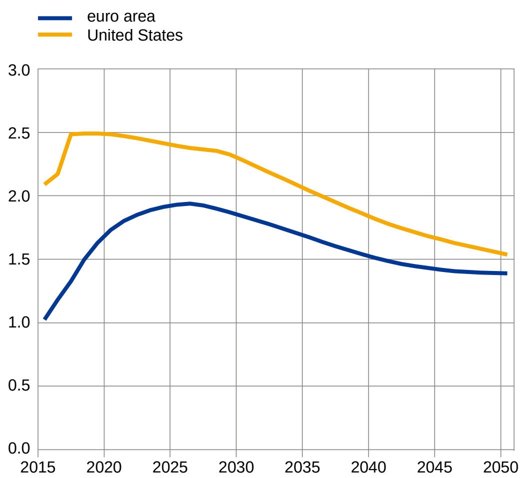


Sources: European Commission and ECB calculations.
Notes: The range of vintages is from the autumn 2008 to the autumn 2014 projections. The latest estimate is from the winter 2015 projections.

Chart D

Long-term potential growth projections for the euro area and the United States

(annual percentage changes)



Source: OECD.

The crisis has also affected the uncertainty related to estimates and projections of potential output, making the measurement of slack in the economy more difficult. Substantial downward revisions to potential growth estimates have been made since 2008 by international institutions as well as the European Commission (see Chart C). Moreover, potential growth is likely to have been overestimated prior to the crisis, as large macroeconomic imbalances in the pre-crisis period proved ex post that growth was unsustainable in many euro area countries.

Long-term outlook

In the medium term the effects of the crisis are expected to fade away and euro area growth is expected to converge to its long-term potential, which might also be supported by the Investment Plan for Europe announced in 2014. According to long-term projections by the OECD, potential growth in the United States is expected to accelerate to 2.5% in the medium term, while potential growth in the euro area is projected to remain lower, although rising. After 2025 growth in both regions is expected to gradually slow down, reaching around 1.5% by 2050 (see Chart D). This projection for the euro area might be optimistic, as it assumes the convergence of TFP growth towards the historical TFP growth of the leading OECD countries, as well as the convergence of product market and trade regulations towards the OECD average. In other words, the projections assume that structural reforms will be fully implemented.

In the euro area, the main factor likely to weigh on potential growth in the long run is demographics. Although some support is expected from an increase in fertility rates and life expectancy as well as inward migration, the euro area population is projected to peak around 2040 before starting to decrease gradually, as migration is unlikely to be able to continue to offset the natural decline in population. Employment is expected to increase only until around 2020, as rising employment rates will continue to offset the expected decline in working-age population until then, but it will start to decline thereafter. These developments are expected to result in a significant increase in the old-age dependency ratio (i.e. in the share of the population aged 65 years or over) from about 28% in 2014 to 50% in 2050. Therefore, in the long run, labour input will make a negative contribution to potential growth. The higher dependency ratios suggest that demographics could also weigh on capital accumulation, as ageing puts pressure on the pension systems and government financing and may lead to higher precautionary savings and lower investment.

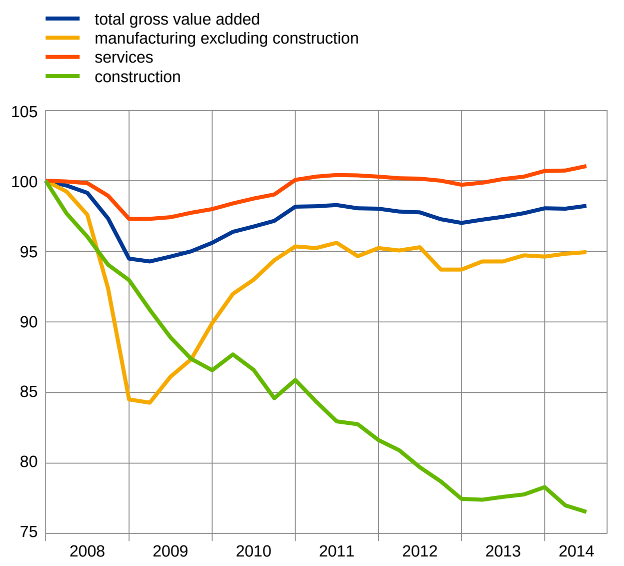
Given that, in the long run, the lack of labour supply is expected to weigh on economic growth, growth must come from productivity and ICT dynamics. As presented above, there is considerable room for improving TFP growth in the euro area. In market services and particularly in distribution services, there has been a large gap in TFP contributions, but also in the boost provided by ICT capital to sectoral growth, between the United States and the euro area (see Chart B). In addition, to avoid a long period of low growth, the euro area needs to catch up with best practices in terms of economic efficiency by improving conditions for innovation and entrepreneurship, as well as labour market institutions, and by relaxing regulations.

Net trade is likely to have made a broadly neutral contribution to growth in 2014 as exports and imports displayed similar growth rates, which were both higher than in 2013. The year started off with relatively weak export growth in the first quarter. This probably reflected a number of factors, such as the deceleration in growth of the world economy, notably in a number of emerging market economies, and the lagged effects of the earlier euro appreciation. Exports rebounded from the second quarter onwards, on account of the recovery in global growth and, as of May, the depreciation of the euro exchange rate. As for imports, they followed a similar path to exports, showing relatively weak growth at the beginning of the year and recovering strongly in the second half.

Chart 11

Euro area real gross value added by economic activity

(index: Q1 2008 = 100)



Source: Eurostat.

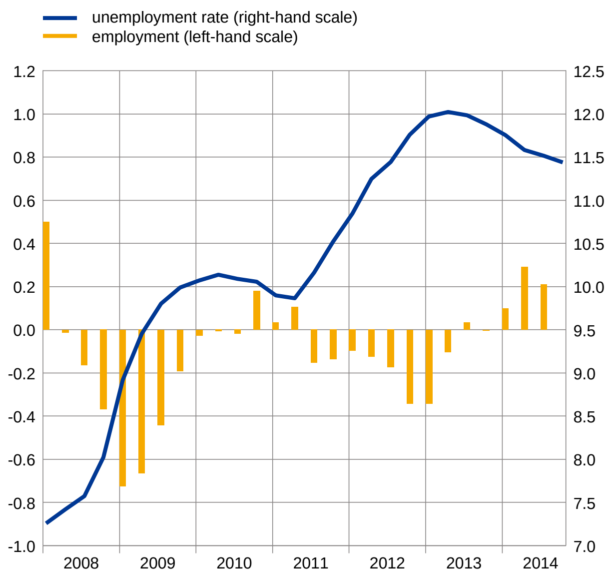
Changes in inventories are also expected to have made a broadly neutral contribution to GDP growth in 2014, in line with the slow recovery that took place in the euro area in the course of the year. This outcome represents an improvement compared with the previous two years, in which inventories were a drag on overall activity.

The recovery in 2014 was relatively broadly based from a sectoral perspective. Value added in both industry excluding construction and services rose, following two years of contraction and of broad stability respectively. The recovery in the services sector has been the most prominent. Services value added stood on average during the first three quarters of 2014 slightly above its pre-crisis level in 2008, while value added in industry excluding construction remained below its pre-crisis level (see Chart 11). At the same time, value added in construction displayed a small decline, which implies that the construction sector has been shrinking for seven consecutive years.

Chart 12

Labour market indicators

(quarter-on-quarter growth rate, percentage of the labour force; seasonally adjusted)



Source: Eurostat.

Labour markets improved somewhat further

Labour markets, which had already started to show signs of improvement in the second half of 2013, recovered further in 2014 (see Chart 12). The number of persons employed, which had declined by 0.8% in 2013, rose slightly in 2014. As a result, by the third quarter of 2014 euro area employment stood about 0.6% above its level one year earlier. This is the highest annual growth rate recorded since the start of the crisis in 2008. Recent evidence also suggests that the speed of employment creation relative to the strength of output growth has somewhat increased since the onset of the crisis in 2008 – albeit with strong cross-country variation. While part of the more intense employment growth response to output growth can be explained by cyclical factors, this positive development might also reflect the impact of structural reforms in labour markets, which have been particularly wide-ranging in some euro area countries.

The rise in employment reflected improvements in the services sector, while the number of persons employed in industry excluding construction was broadly stable compared with 2013. Meanwhile, employment in construction continued to contract in annual terms, albeit at a declining rate. In contrast to 2013, total hours worked increased slightly more than headcount employment in 2014.

Since the acceleration in employment growth was somewhat lower than the increase in output growth, annual productivity growth per person employed averaged around 0.5% over the first three quarters of 2014, which compares with an annual rise of 0.3% in 2013. Although the rise in productivity growth was broadly based across sectors, it largely reflected developments in construction.

The unemployment rate declined further in 2014, even though the rate of decline diminished somewhat throughout the year. The decline in unemployment since the first half of 2013 has been broad-based across gender and age groups. For 2014 as a whole, the unemployment rate averaged 11.6%, compared with an average rate of 12.0% in 2013.

1.4 Price and cost developments

Throughout 2014 headline HICP inflation in the euro area continued its downward trend, mainly reflecting oil and food price developments. The contribution from the services and non-energy industrial goods components was more stable but low, also reflecting low inflationary pressures stemming from domestic sources.

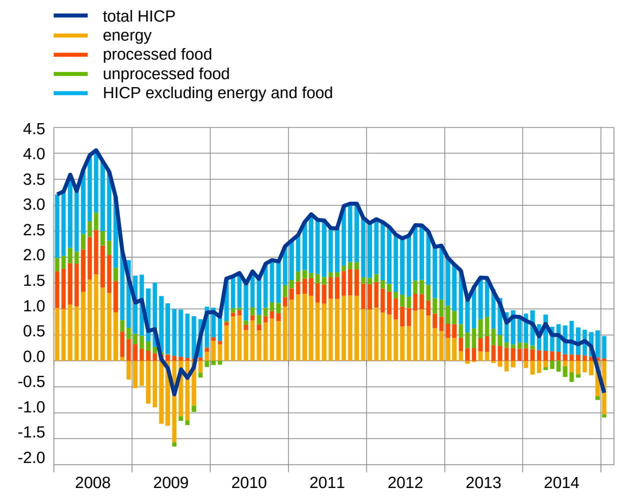
Headline inflation declined further in 2014, driven mainly by oil prices

In 2014 headline HICP inflation in the euro area was 0.4% on average, down from 1.4% in 2013 and 2.5% in 2012. This slowdown was more pronounced than expected in late 2013 and can be attributed primarily to global factors such as falling commodity prices, impacting in particular energy and food prices. Underlying inflation, as measured by the HICP excluding energy and food, was broadly stable in 2014, but remained low, reflecting the weak demand in the euro area over that period.

Chart 13

HICP inflation and contributions by components

(annual percentage changes and percentage point contributions)



Sources: Eurostat and ECB calculations.

Looking at the main components of the HICP in more detail, a large share of the fall in headline annual HICP inflation from the end of 2013 (see Chart 13) can be attributed to the energy component (around 70%). Energy inflation was negative in almost every month of 2014, owing mainly to developments in oil prices in euro terms (see also Box 3). After peaking in mid-June, the price of crude oil denominated in euro had fallen by around 40% by the end of the year, as the depreciation of the EUR/USD exchange rate only partly offset the sharp decline in crude oil prices in US dollar terms. Lower gas prices also added to the downward pressure on energy prices in 2014.

Box 3

The impact of oil prices on euro area inflation

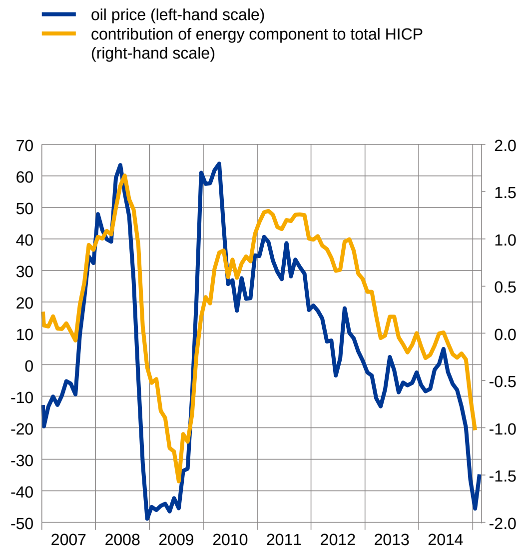
The developments in oil prices in 2014 affected euro area HICP inflation via both direct and indirect channels. The direct effects of oil prices can be gauged from the contribution that energy prices make to overall HICP inflation (see Chart A). Consumer energy prices, and in particular prices for transport and heating fuels, normally react to the euro price of oil with a very short lag of a few weeks and the pass-through is more or less complete. In this respect, the source of the oil price movement, whether supply or demand driven, or whether generated by the oil price in USD or the EUR/USD exchange rate, is typically not relevant. The depreciation of the euro since May 2014 only partly offset the disinflationary impact of the fall in crude oil prices in US dollars in the second half (and especially in the last quarter) of 2014.

At the same time, the elasticity of consumer energy prices with regard to oil price developments depends on the level of oil prices. The reason is the typically large share of (fixed) excise duty in the litre price of fuels (see Chart B as an example for petrol prices). Together with broadly stable refining and distribution margins, this implies that a certain percentage change in the euro price of oil triggers a lower percentage change in consumer energy prices when oil prices are low compared with when they are at high levels. Although updated with a considerable delay, the share of energy goods in the HICP basket increases when oil prices are high, as demand for energy products tends to be inelastic; this, in turn, will increase the elasticity of the HICP to oil prices.

Chart A

Oil price in euro and contribution of the energy component to HICP inflation

(annual percentage changes and percentage point contributions)

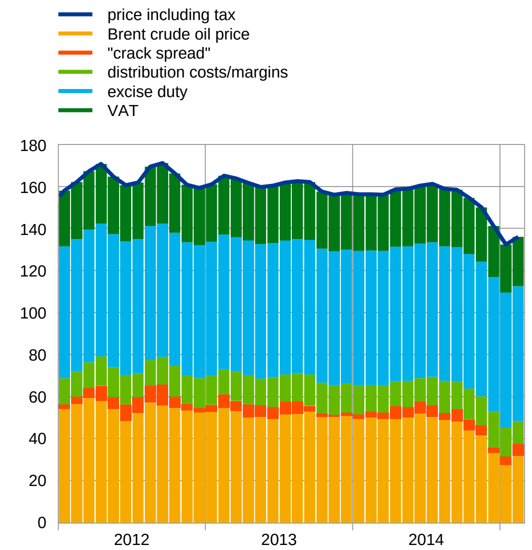


Sources: Thomson Reuters, Eurostat and ECB calculations.

Chart B

Decomposition of consumer petrol prices

(euro cent/litre)



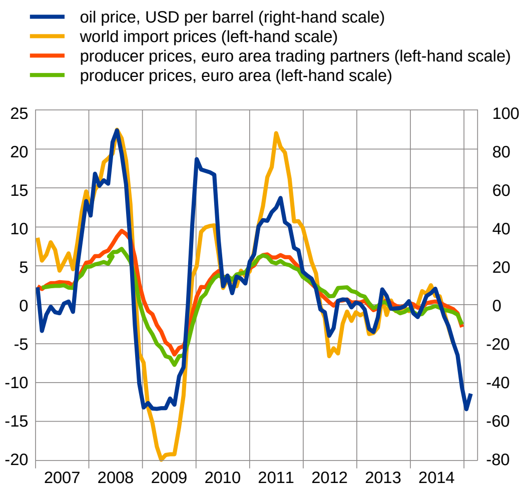
Sources: Bloomberg, Thomson Reuters, European Commission and ECB calculations.

The indirect effects of lower oil prices on consumer prices operate through costs. This is rather obvious in the case of energy-intensive transportation services, but also applies to the production of many other goods and services. Producer prices in the euro area for domestic sales tend to respond to oil price developments with some lag (see Chart C). Overall, the degree of response depends on the adjustment of other costs and/or variation in producers' mark-ups. Prices set by producers in the euro area and those set by producers in trading partner countries (in their national currencies) are highly correlated, suggesting that they are shaped by common global factors.

Chart C

Oil, import and producer prices

(annual percentage changes)



Sources: Thomson Reuters, IMF, Eurostat and ECB calculations.
Notes: The producer prices refer to the manufacturing sector. Euro area trading partners refer to Australia, Bulgaria, Canada, China, Croatia, the Czech Republic, Denmark, Hong Kong, Hungary, Japan, Norway, Poland, Romania, Singapore, South Korea, Sweden, Switzerland, the United Kingdom and the United States.

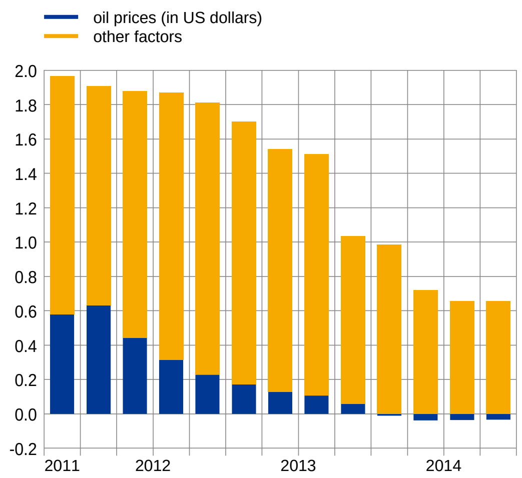
Goods and services covered by the HICP basket can also be imported. Lower oil prices are also likely to influence producer prices in the economies of euro area trading partners and thus the prices of imported items reflected in the euro area HICP.

The quantification of indirect effects is surrounded by a high degree of uncertainty. Chart D shows the estimated indirect effect of oil price developments on euro area consumer prices excluding energy since the latest peak in inflation in the last quarter of 2011. Looking at the period as a whole, the downward trend in HICP inflation excluding energy reflects to a large extent the fading-out of the earlier

Chart D

Estimated impact of crude oil prices on HICP inflation excluding energy

(annual percentage point contributions)



Source: ECB calculations.

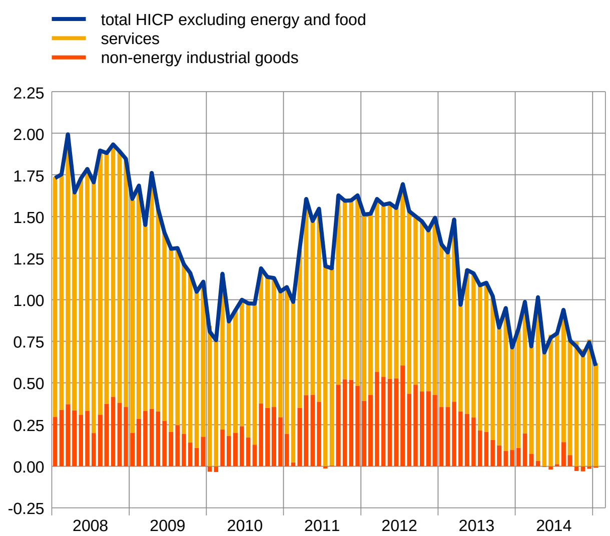
upward impacts from oil prices and, in 2014, the impact turned negative. The reported estimates of indirect impacts characterise average responses over business cycles. The concrete pass-through at each point in time is linked to the behaviour of firms and their ability to adjust margins, which is influenced by the elasticity of demand, the degree of competition and the flexibility of other costs. Also, the pass-through depends on how long firms believe that the oil price movement will last. In the current environment of weak consumer demand and price adjustment needs in some euro area countries, it is conceivable that oil price changes might have a larger impact than in other situations.

Overall, oil price developments dampened euro area HICP inflation in 2014 largely via direct effects on consumer energy prices, but also via indirect effects through lower domestic costs and imported prices. It is important that such temporary developments do not affect longer-term inflation expectations and do not have a more lasting impact on the behaviour of wage and price-setters, which could trigger a more persistent impact on inflation via second-round effects.

Chart 14

HICP inflation excluding energy and food and contributions by components

(annual percentage changes and percentage point contributions)



Sources: Eurostat and ECB calculations.

The contribution of the food component to the fall in headline HICP inflation in 2014 was also substantial, mainly as a result of the more favourable weather conditions than in 2013. Russia's ban on the import of food products appeared to have a limited impact, with any downward pressure being offset by prices normalising after the positive weather-related supply shocks earlier in the year.

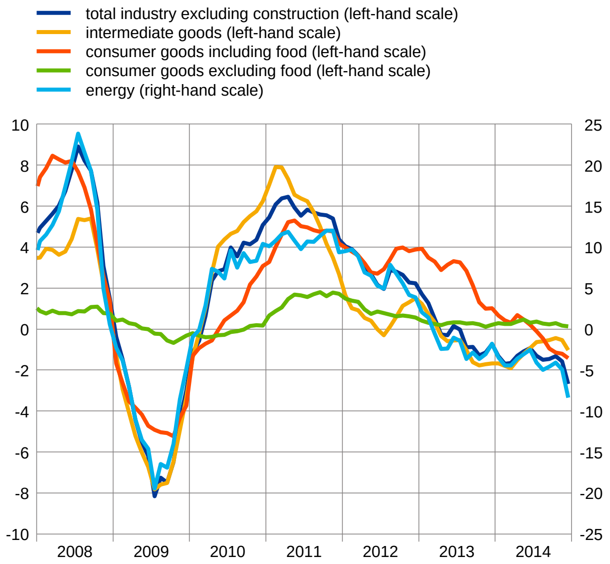
The two remaining components of the HICP, i.e. non-energy industrial goods and services, are more likely to reflect developments in domestic demand. HICP inflation excluding energy and food remained low but broadly stable in 2014, standing at 0.8% on average (see Chart 14). This reflected relatively weak consumer demand, low pricing power among firms, modest wage developments in several euro area countries, the lagged effects of the earlier appreciation of the euro, and indirect effects stemming from the pass-through of lower commodity and energy prices.

Annual non-energy industrial goods inflation continued on the downward trajectory which started in mid-2012 and fell close to its historical lows. This trend was generally broad-based across the individual euro area countries and across goods categories. The annual rates of growth in the prices of durable, semi-durable and non-durable goods declined further in 2014, reflecting lacklustre domestic demand, but also external factors such as weak commodity prices and the past appreciation of the euro, which has an impact on import prices. Looking back over a longer period, non-energy industrial goods inflation was dampened by the rapid fall in the prices of high-tech goods, which are the subject of strong competition among retailers at both the national and international level.

Chart 15

Breakdown of industrial producer prices

(annual percentage changes)



Sources: Eurostat and ECB calculations.

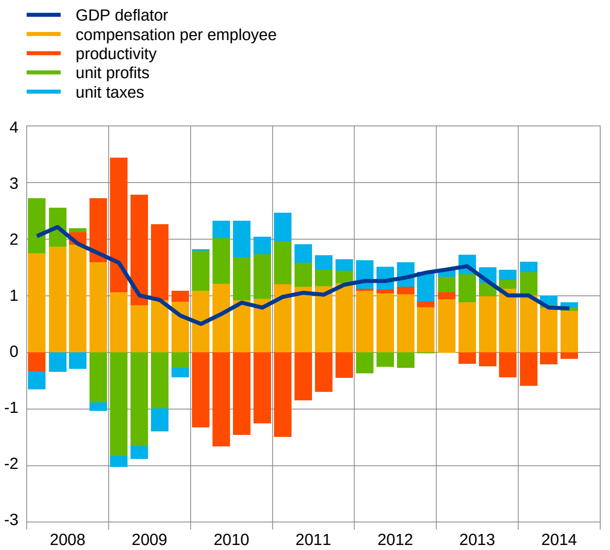
Pipeline pressures on consumer prices for non-energy industrial goods remained weak throughout 2014, reflecting weak energy and non-energy commodity prices, as well as low demand. Inflation in producer prices in the non-food consumer goods industries – which have a large impact on prices for non-energy industrial goods – remained low, hovering around levels just above zero throughout the year. Producer prices in the intermediate goods industries, as well as prices in euro for crude oil and other commodities, suggest that pressures were also subdued at the earlier stages of the price chain (see Chart 15).

Annual services inflation bottomed out in 2014, reflecting a weak recovery in the euro area. It remained at a low level particularly in those countries suffering from market tensions. Items in the services component of the HICP tend to be produced domestically, which means that services prices are more closely linked to developments in domestic demand and labour costs.

Chart 16

Breakdown of GDP deflator

(annual percentage changes and percentage point contributions)



Sources: Eurostat and ECB calculations.

Domestic price pressures remained low

Domestic cost pressures stemming from labour costs eased further in the first three quarters of 2014, in line with the continued weakness in labour markets (see Chart 16). The pattern of wage growth at the euro area level continued to conceal considerable divergences in wage developments across countries. Most of the weakening in wage dynamics stemmed from substantial wage moderation in those countries suffering from market tensions, reflecting weak economic activity and the impact of reforms to enhance wage and price flexibility and boost competitiveness.

Growth in compensation per employee for the euro area as a whole declined to just above 1% in the third quarter of 2014. By contrast, the annual rate of growth in negotiated wages was somewhat higher, suggesting a negative wage drift in the euro area over this period. The annual rate of growth in unit labour costs stayed low at levels around 1% and the slight increase towards the end of the year reflected weaker productivity growth which more than offset the moderation in wage growth.

Domestic cost pressures stemming from profit developments also remained low in 2014. The recovery in profits (measured in terms of gross operating surplus) continued in the first three quarters of 2014, but slowed in the course of the year. Profits per unit of output added only slightly to the increase in the GDP deflator in 2014.

Survey and market-based inflation expectations reacted to low inflation data releases and sharply declining energy prices. The dampening impact was particularly strong in the case of short-term inflation expectations, which moved in tandem with the fall in headline inflation. However, from mid-2014 medium to long-term inflation expectations also began to decline, albeit staying close to 2% when gauged from surveys. The Survey of Professional Forecasters for the fourth quarter of 2014 showed five-year-ahead inflation expectations of 1.8%, while the level of longer-term inflation expectations in the October 2014 Consensus Economics survey was 1.9%. The decline in financial indicators of inflation expectations was stronger: in December 2014 the long-term forward inflation-linked swap rate stood at around 1.7%. These developments may have been affected by changes in inflation risk premia.

1.5 Money and credit developments

In an environment of very low interest rates, two developments in 2014 stand out. Money growth remained subdued but started to recover, while the contraction in credit growth reached a trough.

Money growth remained subdued while showing increasing signs of a recovery

Broad money growth in terms of the monetary aggregate M3 remained at subdued levels, but recovered over the course of 2014 (see Chart 17). In December 2014 annual M3 growth stood at 3.8%, compared with 1.0% at the end of 2013. As regards monetary aggregates, two countervailing effects can be distinguished: while weak economic activity and investors’ search for yield limited monetary dynamics, the ongoing preference for liquidity in an environment of very low interest rates supported money growth. In addition, regulatory changes that encourage banks to increase their reliance on retail deposit-based funding supported M3 growth. Overall, the recovery in broad money growth followed the ECB’s interest rate cuts and the adoption of further non-standard monetary policy measures.

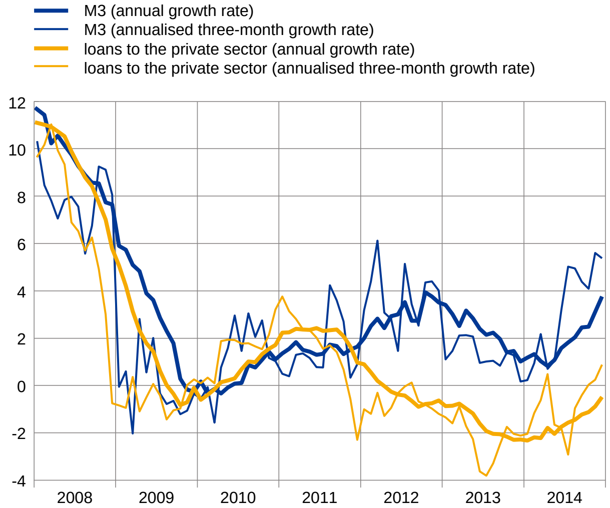
Ongoing credit contraction reached a trough

Credit developments remained subdued, but the ongoing credit contraction reached a trough in 2014, and a moderate turnaround in loan dynamics was observed, in particular for non-financial corporations. The annual growth of MFI credit to euro area residents recovered throughout the year and converged to zero at the end of 2014. The annual rate of change in MFI credit stood at -0.1% in December, up from -2.0% in December 2013. This increase, which primarily occurred in the second half of the year, mainly reflected developments in loans to the private sector (see Chart 17) and in credit to general government. It confirms that a broad-based turnaround in loan dynamics occurred around the second quarter of 2014, in particular for non-financial corporations. This assessment is further supported by the euro area bank lending surveys. They indicate that, in addition to stronger loan demand, factors related to banks' cost of funds and balance sheet constraints, together with increased competition, contributed to an easing of credit standards for loans both to enterprises and to households for house purchase. While the annual growth rate of loans to households increased gradually, the decline in loans to non-financial corporations abated significantly over the year. This improvement in credit dynamics was significant since, in addition to relatively tight credit standards, weak credit dynamics constituted a constraint for the recovery in the euro area, keeping the degree of slack elevated and acting as a source of downward pressure on the medium-term inflation outlook. It was facilitated by improvements in financial market conditions and a sizeable reduction in bank funding costs, not least related to the ECB's standard and non-standard monetary policy measures.

Chart 17

M3 and loans to the private sector

(annual percentage changes; adjusted for seasonal and calendar effects)

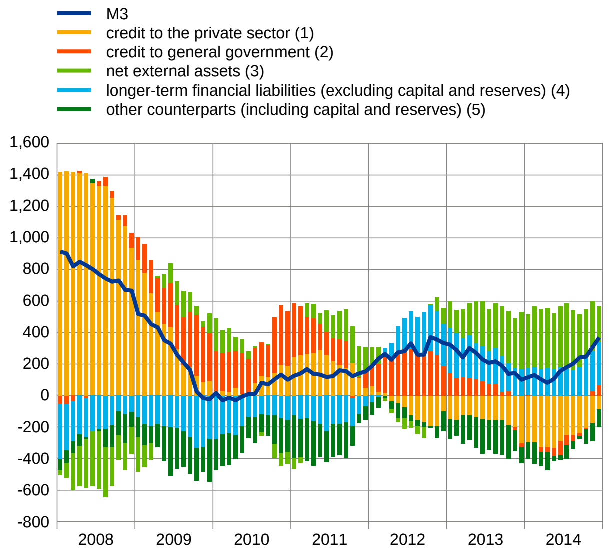


Source: ECB.

Chart 18

Counterparts of M3

(annual flows; EUR billions; adjusted for seasonal and calendar effects)



Source: ECB.
Notes: M3 is shown for reference only (M3 = 1+2+3-4+5).
Longer-term financial liabilities (excluding capital and reserves) are shown with an inverted sign, since they are liabilities of the MFI sector.

International investors also drove M3 dynamics

An assessment of the counterparts of M3 (see Chart 18) shows that during 2014 M3 dynamics were driven in particular by the preference of international investors for euro area assets. Furthermore, shifts away from longer-term financial liabilities supported M3 growth.

The annual rate of change in MFI longer-term financial liabilities (excluding capital and reserves) held by the money-holding sector declined in the course of the year to stand at -5.5% in December, compared with -3.3% at the end of 2013. Regarding the other counterparts of M3, euro area banks continued to strengthen their capital positions, not least in view of the ECB's comprehensive assessment of the balance sheets of significant banks. Finally, the accumulation of net external assets by euro area MFIs remained very supportive to M3 growth. In the 12 months to the end of July 2014, the net external asset position of euro area MFIs increased by a record amount of €412 billion, reflecting current account surpluses and a generally strong interest on the part of international investors in purchasing euro area securities. Its contribution decreased over the remainder of the year, as the preference of investors for acquiring euro area securities moderated.

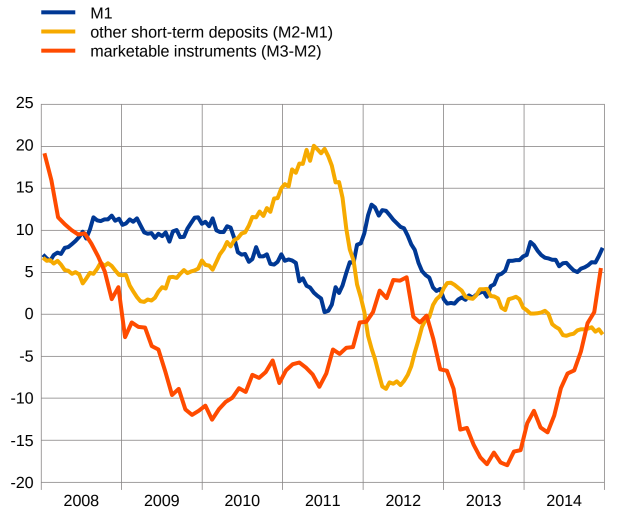
The impact of very low interest rates

As regards the main components of M3, the very low ECB policy rates and money market interest rates drove the robust annual growth of narrow money (i.e. M1), which stood at 7.9% in December 2014, compared with 5.7% in December 2013 (see Chart 19). The preference of the money-holding sector for the most liquid assets, in particular overnight deposits, points to a continued build-up of cash buffers in 2014. M1 benefited from the elevated growth of overnight deposits held by both households and non-financial corporations. The low and declining remuneration of less liquid monetary assets (see Chart 20) contributed to the ongoing contraction of short-term deposits other than overnight deposits (i.e. M2 minus M1), the pace of which started to moderate in May 2014. This recovery was mainly visible in short-term time deposits. The pace of contraction in marketable instruments (i.e. M3 minus M2), which have a relatively small weight in M3, also slowed significantly, in particular

Chart 19

Main components of M3

(annual percentage changes; adjusted for seasonal and calendar effects)

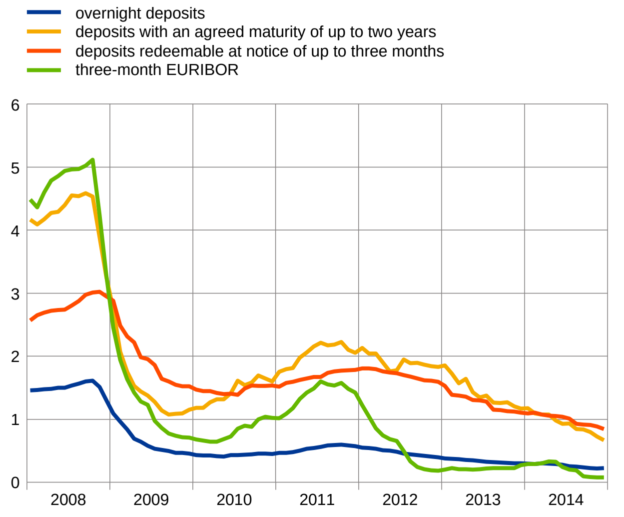


Source: ECB.

Chart 20

MFI interest rates on short-term deposits and the three-month EURIBOR

(percentages per annum)



Source: ECB.

from June 2014, and annual growth rates reached positive territory in December 2014. While holdings of short-term debt securities issued by MFIs continued to decline at a rapid pace, the annual growth rate of repurchase agreements and of money market fund shares/units turned positive at the end of 2014.

1.6 Fiscal policy and structural reforms

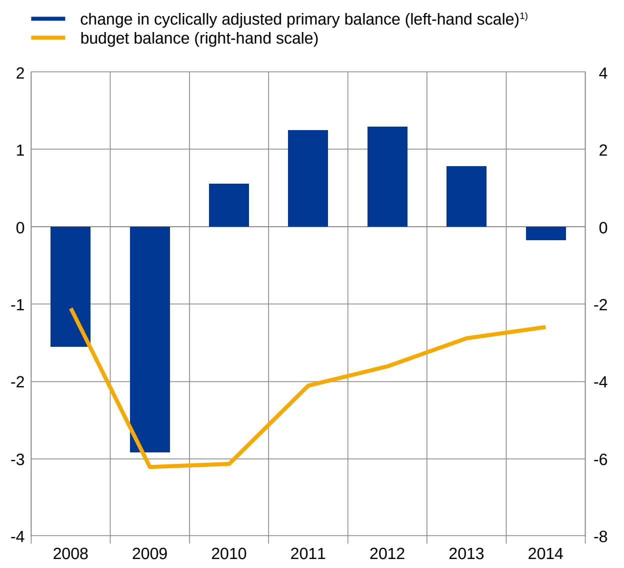
Fiscal consolidation slowed down in 2014, in part reflecting the progress achieved in past years. To ensure sustainable public finances, further fiscal effort is needed by most euro area countries in line with the strengthened fiscal governance framework. Given the weakness of the economic recovery and of the long-term growth potential, it is particularly important for fiscal consolidation to be pursued in a growth-friendly and differentiated manner and for structural reforms to be pursued in a determined manner. As also highlighted by the ECB on several occasions in 2014, the fiscal governance framework provides sufficient flexibility to account for the short-term budgetary costs of major structural reforms. However, progress in structural reforms has lost momentum during the past two years, which is a concern given that growth-enhancing structural reforms are crucial to boost productivity, employment and thus potential growth in the euro area.

Fiscal consolidation slowed down in 2014

Chart 21

Budget balance and fiscal stance

(as a percentage of GDP)



Sources: Eurostat and December 2014 Eurosystem staff macroeconomic projections.
1) Change in the cyclically adjusted primary balance net of the budgetary impact from government assistance to the financial sector.

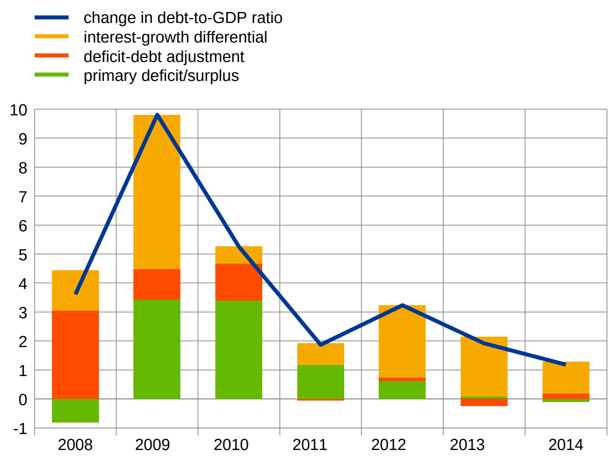
Although fiscal consolidation continued in the euro area in 2014, its pace slowed notably, partly reflecting the progress achieved in past years (see Chart 21). In the December 2014 Eurosystem staff macroeconomic projections, the euro area general government fiscal deficit was projected to have declined from 2.9% of GDP in 2013 to 2.6% of GDP in 2014.[3] This was in line with the European Commission's winter 2015 economic forecast. The reduction in the 2014 deficit was mainly due to the cyclical improvement, reflecting in particular higher revenues from indirect taxes as a result of stronger private consumption, while structural fiscal adjustment had come to a standstill. Thus, the fiscal policy stance, as measured by the change in the cyclically adjusted primary balance, was broadly neutral in 2014.

General government debt in the euro area continued to increase in 2014. According to the December 2014 Eurosystem staff macroeconomic projections, the debt level reached 92% of GDP in 2014, up from 91%

3 The euro area aggregate used in this section includes Lithuania.

Chart 22
The main drivers of general government debt developments

(as a percentage of GDP)



Sources: Eurostat and December 2014 Eurosystem staff macroeconomic projections.

of GDP in 2013. This increase reflects high interest expenditure and the debt-increasing impact of the deficit-debt adjustment, which was largely related to financial sector support. These two factors were only partly offset by a small primary surplus and higher economic growth (see Chart 22).

Another factor explaining changes in fiscal data is the transition to the new European System of Accounts 2010 (ESA 2010). Its impact was limited for the deficit, but more pronounced for the debt figures. For 2013 the fiscal deficit-to-GDP ratio was reduced by 0.2 percentage point for the euro area as a whole, while the debt ratio was lowered by 1.6 percentage points, largely on account of an upward revision of the GDP denominator. For some euro area countries, the impact of the transition to the ESA 2010 was more pronounced, namely for Ireland, Luxembourg and Cyprus.[4]

Progress in fiscal consolidation varied across countries

At the country level, progress in fiscal consolidation was evident from the increasing number of countries exiting their excessive deficit procedures (EDPs). In recent years, first Finland, then Germany, Italy and Latvia have achieved a sustainable correction of their excessive deficits. This positive trend continued in 2014 with the EDP being abrogated for Belgium, Austria and Slovakia (which had deadlines to correct their excessive deficits by 2013), as well as for the Netherlands, one year ahead of its deadline. Moreover, Malta is expected to have achieved a correction of its excessive deficit by its 2014 deadline.

More fiscal effort is needed

Nevertheless, it became clear in 2014 that in several countries the fiscal effort was insufficient to ensure compliance with the EDP requirements. In fact, on the basis of the European Commission's winter 2015 forecast, a few countries were seen to be at risk of not meeting their annual EDP targets for 2014 and beyond, even though the targets had been loosened following the past EDP deadline extensions for a number of countries. To foster compliance with the requirements of the Stability and Growth Pact, the European Commission made use in 2014 of its new powers under the EU's strengthened economic governance framework[5] and on 5 March 2014 issued autonomous recommendations to France and Slovenia, in which it requested the necessary measures to correct the excessive deficits by the 2015 deadlines. On

4 See the box entitled "The impact of the European System of Accounts 2010 on euro area macroeconomic statistics", *Monthly Bulletin*, ECB, November 2014.

5 Article 11(2) of Regulation (EU) 473/2013 ("two-pack" regulation).

2 June the Commission said that it considered France to have broadly responded and Slovenia to have partially responded to the autonomous recommendations.

In addition, in the fiscal-related country-specific recommendations (CSRs) adopted in July 2014 by the ECOFIN Council, most euro area countries were asked to reinforce their budgetary strategies in 2014 and to ensure in their budgetary plans for 2015 compliance with the Stability and Growth Pact. In mid-October 2014 the euro area countries that were not subject to an EU-IMF financial assistance programme submitted their draft budgetary plans. In its opinions published on 28 November, the Commission judged that the draft budgetary plans of seven countries posed a risk of non-compliance with the Stability and Growth Pact. This group comprises France, Spain, Malta and Portugal, which are still subject to an EDP, as well as Italy, Belgium and Austria, which exited their EDPs in 2012 or later. For Belgium, France and Italy, the Commission announced detailed follow-up assessments in early 2015.[6] Only five draft budgets were regarded as compliant and four draft budgets as broadly compliant with the Pact. In its follow-up assessments published on 27 February 2015, however, the Commission decided not to step up the EDP for France and concluded that Italy and Belgium were found compliant with the preventive arm requirements and the debt rule.[7]

Fiscal consolidation should be growth-friendly

Given the slow pace of the economic recovery in 2014, it is very important to support the recovery through a growth-friendly fiscal adjustment. This is particularly relevant for those countries that have no fiscal space and need to increase their fiscal efforts. To this end, cutting unproductive spending can free up funds to preserve productive spending. Reform efforts on the revenue side should focus on addressing the distortionary impact of taxation as well as tax evasion. A key focus here is on reducing the high tax wedges in some countries. Against this background, the Eurogroup in September 2014 agreed on a set of common principles which should guide future tax reforms.[8]

The Stability and Growth Pact provides sufficient flexibility

As also confirmed by the European Council at its June 2014 meeting, the existing rules of the Stability and Growth Pact provide sufficient flexibility to account for adverse economic developments and the short-term budgetary costs of major structural reforms, such as pension reforms. On 13 January 2015 the European Commission issued a communication which clarifies and extends the flexibility in applying the rules of the Pact in three major areas, namely the treatment of structural

6 For more information, see the Commission opinions published on 28 November 2014.

7 See the Commission reports published on 27 February 2015.

8 See the Eurogroup statement published on 12 September 2014.

reforms, investment and cyclical conditions.[9] The available flexibility within the Pact must be used in a prudent manner, as highlighted by the ECB on several occasions (see Box 4).[10]

Box 4
Changes in the fiscal and macroeconomic governance framework

In response to the financial and economic crisis, the EU governance framework was strengthened in 2011 and 2013 with a view to helping restore confidence in public finances, through the "six-pack", the fiscal compact and the "two-pack" regulations. In November 2014 the European Commission reviewed the effectiveness of the changes made to parts of the governance framework. The review was mainly backward-looking and found that, overall, the procedures worked properly.

Generally, the reformed governance framework has proved to be very important as it has helped to foster countries' fiscal consolidation efforts, to better identify macroeconomic imbalances and to provide country-specific recommendations. Nevertheless, as also highlighted by the European Commission in its review, its implementation needs to be strengthened, as consolidation efforts remain uneven across Member States and the identification of macroeconomic imbalances has not led to an appropriate use of the tools provided in the macroeconomic imbalance procedure to correct these imbalances. Furthermore, the implementation of the country-specific recommendations remains unsatisfactory.

On the fiscal side, the Commission's review confirmed that the Stability and Growth Pact has acted as an anchor of confidence and the strengthened fiscal governance framework has provided sound guidance for the Member States' conduct of fiscal policies, with a focus on preserving fiscal sustainability. It is crucial that the rules of the Pact are applied in a consistent manner. This is essential to preserve the credibility of the new governance framework and effectively prevent the re-emergence of fiscal imbalances. The national fiscal councils which many countries have established in recent years and the transposition of the fiscal compact into national legislation are expected to play a key role in this respect. They can help in achieving better fiscal discipline and increasing national ownership of EU fiscal rules (for more details, see the box entitled "Fiscal councils in EU countries", *Monthly Bulletin*, ECB, June 2014).

As regards macroeconomic developments and economic structures, the macroeconomic imbalance procedure has been a valuable tool to identify imbalances and their degree of severity. It is important that this procedure is implemented in a more consistent and transparent manner, in particular by making full use of the excessive imbalance procedure in cases where excessive imbalances are identified.

The European Commission called for contributions to its mid-term review of the Europe 2020 strategy through a public consultation. The Eurosystem, in its contribution, stressed that the

9 For an assessment, see the box entitled "Flexibility within the Stability and Growth Pact", *Economic Bulletin*, Issue 1/2015, ECB.

10 See, for example, Mario Draghi, "Recovery and reform in the euro area", speech delivered at the Brookings Institution, 9 October 2014.

Europe 2020 strategy should focus on reforms that have an impact on potential growth and create employment, such as structural reforms in labour and product markets as well as reforms affecting overall business conditions. The contribution also underlined that the successful implementation of this reform agenda is dependent on the full, strict and consistent implementation of the strengthened economic governance framework.

In the longer term, and given that structural reforms are not only in a country's own interest but also in the interest of the euro area as a whole, EU governance of structural reforms should be further strengthened to help countries to improve competitiveness, productivity, employment and resilience within the euro area. Looking ahead, this could involve a move from rules to institutions and from coordination to joint decision-making. The forthcoming report by the President of the European Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup and the President of the ECB, on next steps on better economic governance in the euro area will be a key starting point for further reflection on these matters, as evidenced by the Analytical Note prepared by the four Presidents and circulated to the Heads of State or Government.

Progress in structural reforms has lost momentum since 2013

Progress in structural reforms has lost momentum during the past two years, which is a concern given that growth-enhancing structural reforms are crucial to boost productivity, employment and thus potential growth in the euro area. While the need to make progress on structural reforms varies across countries, according to their level of imbalances and vulnerabilities, most euro area countries are still characterised by significant rigidities in labour and product markets. The push for reform was relatively strong in 2011-13 in countries that were subject to financial assistance programmes, while it was much more limited in the other countries, in particular during 2013 following the significant reduction of financial market pressures in stressed non-programme countries. Since the end of 2013 reform progress has lost further momentum across most euro area countries, against the background of the winding-up of assistance programmes, a buoyant financial market environment, reform fatigue and electoral cycle considerations (see Box 4). Notwithstanding a number of policies and measures that go in the right direction, euro area countries have fallen substantially short in implementing reforms. In some cases, measures actually go in the wrong direction, and past reforms have been watered down or reversed.

Reform recommendations not fully addressed

During 2014 the implementation of the CSRs continued to be relatively disappointing. According to the European Commission, only some or limited progress has been observed on the reform recommendations issued to euro area countries that were not subject to assistance programmes (see Table 1). None of the euro area countries has fully addressed any of the 2014 recommendations. While reform efforts have been stepped up in some countries (in Slovenia, in particular, substantial progress has been made in three out of the eight CSRs), in the majority of countries progress has been rather limited and not commensurate with the remaining vulnerabilities. Continued reform effort remains important in all countries. In particular, decisive action is needed in the euro area countries identified by the European Commission in February 2015 as having excessive imbalances, i.e. France, Italy and Portugal, and in the other euro area countries under specific monitoring by the Commission in 2014, i.e. Spain, Ireland and Slovenia.[11]

The significant slowdown of reform efforts in euro area countries was confirmed by the OECD in its 2015 “Going for Growth” report. In particular, reform activity was found to remain weak in the less vulnerable euro area countries and to be declining in the more vulnerable euro area countries. The timid reform progress stood in stark contrast to the still very large challenges and structural problems existing in most euro area countries. Compared with 2008, sovereign and private debt levels, as well as unemployment rates – especially for the young and long-term unemployed – were significantly higher in 2014. Investment as a share of GDP continued to disappoint and the long-term potential growth outlook was much lower in 2014 than six years earlier. The higher stock of debt and weaker growth outlook implied that it would be very challenging to reabsorb the employment losses within a reasonable time frame without a major impulse for reforms.

Table 1

European Commission assessment of the implementation of the 2014 country-specific recommendations

Reform recommendations	BE	DE	EE	ES	FR	IE	IT	LV	LT	LU	MT	NL	AT	PT	SI	SK	FI
1	limited progress	limited progress	limited progress	some progress	limited progress	some progress	limited progress	some progress	some progress	some progress	substantial progress	some progress	limited progress	some progress	some progress	limited progress	some progress
2	limited progress	limited progress	some progress	some progress	some progress	some progress	some progress	some progress	limited progress	limited progress	limited progress	limited progress	some progress	some progress	limited progress	limited progress	some progress
3	substantial progress	some progress	some progress	some progress	limited progress	some progress	limited progress	limited progress	limited progress	limited progress	some progress	substantial progress	limited progress	some progress	substantial progress	some progress	some progress
4	some progress	limited progress	some progress	some progress	some progress	limited progress	some progress	some progress	no progress	limited progress	some progress	some progress	limited progress	some progress	substantial progress	limited progress	limited progress
5	some progress		limited progress	limited progress	limited progress	some progress	some progress	some progress	substantial progress	no progress	some progress		substantial progress	substantial progress	some progress	limited progress	some progress
6	limited progress			some progress	limited progress	some progress	some progress		some progress					some progress	substantial progress	limited progress	
7				some progress	some progress	limited progress	limited progress							limited progress	some progress		
8				some progress			limited progress							some progress	some progress		

Legend: fully addressed; substantial progress; some progress; limited progress; no progress

Source: European Commission.
Notes: The following categories are used to assess progress in implementing the 2014 CSRs: No progress: the Member State has neither announced nor adopted any measures to address the CSR. This category also applies if a Member State has commissioned a study group to evaluate possible measures. Limited progress: the Member State has announced some measures to address the CSR, but these measures appear insufficient and/or their adoption/implementation is at risk. Some progress: the Member State has announced or adopted measures to address the CSR. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases. Substantial progress: the Member State has adopted measures, most of which have been implemented. These measures go a long way towards addressing the CSR. Fully addressed: the Member State has adopted and implemented measures that address the CSR appropriately.

[11] See *Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances*, European Commission, 25 February 2015.

Looking beyond 2014, the implementation of credible and decisive growth-enhancing structural reforms is critical

Looking ahead, in order to tackle the major structural bottlenecks which still existed in 2014, credible and decisive growth-enhancing reforms are more important than ever.[12] The call to strengthen the reform effort is a call for high sustainable growth. This is indispensable to bring the unemployment rate back to lower levels and to support debt sustainability. In terms of the sequencing of reforms, policies which have the capacity to increase expected potential growth and confidence, especially reforms of product markets and framework conditions, are particularly urgent. Special attention should be given to reforms which decisively tackle the still very large number of bottlenecks in framework and business environment conditions and in areas such as public (and tax) administration, judicial systems, excessive rents in sectors sheltered from competition and distortions in labour markets, such as nominal rigidities (e.g. limited wage adjustment) and real rigidities (e.g. segmentation).

There are still too many bottlenecks in the business environment, for example excessive bureaucracy, which hinder an efficient allocation of resources and prevent a swifter recovery of private investment. Private investment is also being hampered by insufficient corporate debt restructuring tools and insolvency laws. Despite some progress in certain countries in 2014, policy measures in this area need to be stepped up further to facilitate the deleveraging process of firms (and households). Moreover, measures related to increasing competition in sheltered services sectors continue to be very difficult to implement, and many countries need to take significant policy action to increase competition by allowing new and often more productive and innovative firms to enter these markets. If reforms are credible and frontloaded, the positive impact on confidence, investment, job creation and growth will in general be much larger than possible negative impacts from short-term downward price pressures. There is at present no compelling evidence of large short-term costs stemming from reforms.[13] In fact, the crisis has clearly shown that there is no alternative to structural reforms to lift growth and that postponing difficult decisions will only increase the cost of adjustment later on. A coherent, comprehensive and credible strategy for reforms is crucial not only to maximise the long-term benefits of reforms, but also to share the burden of the adjustment in an equitable manner.

12 See Benoît Cœuré, “Structural reforms: learning the right lessons from the crisis”, keynote speech at the economic conference, Latvijas Banka, Riga, 17 October 2014.

13 See “Structural reforms at the zero lower bound”, *Quarterly Report on the Euro Area*, Vol. 13, No 3, European Commission, 2014.

2 Expanding the toolbox: monetary policy at the effective lower bound for key ECB interest rates

Against the backdrop of a subdued inflation outlook coupled with weak growth momentum, the Eurosystem has adopted a number of major additional monetary policy measures since June 2014.

The policy package introduced in 2014 included three main elements: reducing the key ECB interest rates to the effective lower bound; introducing a series of targeted longer-term refinancing operations (TLTROs); and launching two purchase programmes for selected private sector assets. The package aimed to restore the normal transmission of monetary policy as well as to provide further monetary accommodation, thereby supporting lending to the real economy and the euro area recovery in order to maintain price stability over the medium term.

The measures adopted in 2014 led to a further considerable easing of the effective monetary policy stance, with the liquidity injections via the TLTROs and asset purchase programmes set to reach their full scale over the subsequent quarters. In this context, the Governing Council communicated its intention to sizeably increase the Eurosystem's balance sheet in order to provide a sufficient degree of monetary stimulus to raise annual HICP inflation rates to levels below, but close to, 2%. Moreover, the Governing Council remained unanimous in its commitment to using additional unconventional instruments within its mandate, should it become necessary to further address risks of too prolonged a period of low inflation.

In line with this commitment, in early 2015 the Governing Council conducted a thorough reassessment of the outlook for price developments and of the monetary stimulus achieved so far. It concluded that the medium-term inflation outlook had weakened, and that the monetary policy measures decided since June 2014, while generating a satisfactory pass-through of the amount of liquidity injected to private sector borrowing costs, did not result in a sufficient quantity of liquidity. The Governing Council judged the prevailing degree of monetary accommodation to be insufficient to adequately address heightened risks of too prolonged a period of low inflation. Therefore, at its meeting on 22 January 2015, the Governing Council decided to launch an expanded asset purchase programme and to change the pricing of the six remaining TLTROs.[14]

2.1 The monetary policy environment required decisive ECB action

In 2014 the Eurosystem conducted its monetary policy in an environment which was challenging, with the economic recovery remaining weak, inflation gradually decreasing, monetary and credit dynamics remaining subdued and monetary policy transmission still being impaired.

14 For details, see the box entitled "The Governing Council's expanded asset purchase programme", *Economic Bulletin*, Issue 1/2015, ECB.

As described in detail in Section 1 of Chapter 1, the gradual economic recovery that took hold over the second half of 2013 continued in early 2014. However, towards mid-2014 the euro area recovery showed signs of a loss in momentum, as weaker domestic demand, together with increased geopolitical tensions and insufficient implementation of structural reforms in some euro area countries, negatively affected economic conditions. While certain temporary factors related to calendar effects and weather conditions also contributed to the weakness, high unemployment and sluggish investment behaviour continued to be a drag on economic dynamism. In 2014 as a whole, real GDP increased by 0.9%.

As discussed above, headline inflation rates were low and declined in the course of the year, with average annual HICP inflation in 2014 standing at 0.4%. The decline in HICP inflation was mainly driven by developments in energy and food prices, as well as – during the first few months of the year – the impact of contemporaneous and past exchange rate appreciation. HICP inflation excluding energy and food was also subdued, pointing to weakness in broad aggregate demand. Continuously low inflation and sharply declining energy prices affected inflation expectations. The dampening impact was particularly strong for short-term inflation expectations, which moved in tandem with the fall in headline inflation. From the summer of 2014 medium to long-term inflation expectations also began to decline visibly.

As already noted, euro area monetary and credit dynamics were still weak in 2014, although both showed signs of a recovery in the course of the year. While M3 growth was supported by higher M1 growth reflecting an ongoing preference for liquidity in an environment of low interest rates, the slow pace of the economic expansion limited monetary dynamics.

Credit developments were subdued, despite the first signs of a turnaround reflecting the broad easing in borrowing conditions for euro area MFIs. Loans to the private sector contracted, as positive flows of credit to households were more than offset by still negative flows of credit to non-financial corporations. Credit conditions for households and firms remained tight, especially in some euro area countries, as improvements in financial conditions and – in particular – past monetary policy impulses were transmitted only imperfectly to private borrowing costs. As a result, bank lending rates were less responsive to policy changes, and remained relatively high despite the ECB’s accommodative monetary policy stance. Restrictive borrowing conditions in some countries suppressed aggregate demand and contributed to economic weakness. Weak credit dynamics constrained the recovery in the euro area, thus exerting downward pressure on the medium-term inflation outlook.

Although financial market sentiment improved over the course of the year, there were occasional bouts of volatility. In addition, financial market fragmentation, while continuing to recede, remained elevated. As a result, significant heterogeneity persisted in financing conditions for households and firms across euro area countries. However, the monetary policy measures undertaken by the ECB were successful in contributing to an easing of constraints on bank funding. The completion of the ECB’s comprehensive assessment in October, and the related strengthening of bank balance sheets and access to market funding, is also expected to further ease bank funding conditions and banks’ willingness to lend.

Against this backdrop of a deteriorating inflation outlook, weak growth momentum, subdued monetary and credit dynamics and still impaired monetary policy transmission, the Governing Council has adopted a comprehensive package of measures since June 2014. This package aims to enhance the transmission of monetary policy as well as to provide further monetary accommodation. In particular, by bringing the average borrowing costs for households and firms down to levels that are more consistent with the intended policy stance, the measures support lending to the real economy. Moreover, they are in line with the Governing Council's forward guidance on the key ECB interest rates, contributing to the maintenance of price stability over the medium term.

2.2 The June-October monetary policy package

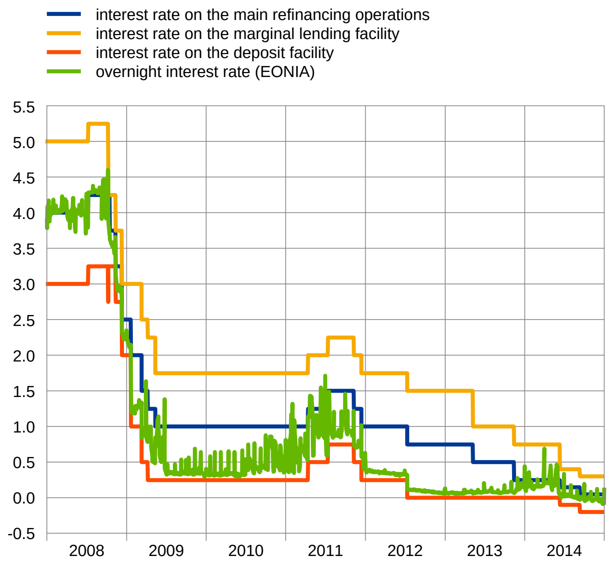
The policy package introduced between June and October included three main elements: reducing the key ECB interest rates to the effective lower bound; introducing a series of TLTROs; and launching two purchase programmes for selected private sector assets.

The measures were designed to have a significant impact on credit conditions for households and firms in the euro area. They were also aimed at supporting the anchoring of medium to long-term inflation expectations, in line with the Governing Council's price stability objective. In addition, the measures reflected significant and increasing differences in the monetary policy cycle between major advanced economies.

Chart 23

ECB interest rates and the overnight interest rate

(percentages per annum; daily data)



Sources: ECB and Thomson Reuters.

Key ECB interest rates reached the effective lower bound

Key ECB interest rates were reduced to the effective lower bound. The interest rate on the main refinancing operations (MROs) of the Eurosystem and the rate on the deposit facility were lowered in two steps by a total of 20 basis points, to 0.05% and -0.20% respectively, while the rate on the marginal lending facility was reduced in two steps by a total of 45 basis points, to 0.30% (see Chart 23). The cut in policy rates was in line with the Governing Council's forward guidance.[15]

Moving the deposit facility rate into negative territory strengthened the impact of the reduction in the MRO rate and helped maintain the width of the interest rate corridor, providing an incentive for banks to trade in interbank markets, which is a precondition for satisfactory market functioning, market-driven price discovery and effective market discipline. Accordingly, the rate cut had a sizeable impact on spot as well as forward money market rates, while turnover in very short-term money markets remained largely unchanged.

15 For details, see the box entitled "The Governing Council's forward guidance on the key ECB interest rates", *Monthly Bulletin*, ECB, July 2013.

The implementation of the decision to introduce negative deposit rates proceeded smoothly, while some adjustments to the remuneration of certain Eurosystem balances were required, as shifts in holdings between accounts could otherwise have undermined the negative rate policy. In particular, the ECB made sure that the negative rate also applied to average reserve holdings in excess of the minimum reserve requirements and certain other deposits held with the Eurosystem, as detailed in a press release on 5 June 2014.

Targeted longer-term refinancing operations provide better access to credit

A series of TLTROs was announced on 5 June 2014 and aimed to improve bank lending to the euro area non-financial private sector. TLTROs provide long-term funding at attractive terms and conditions over a period of up to four years for all banks that meet certain benchmarks applicable to their lending to the real economy. The choice of this measure reflected the predominantly bank-based financing structure of the euro area economy and the significance of weak bank lending as a factor holding back the recovery. By providing incentives for lending to the real economy, the TLTROs were aimed at enhancing monetary policy transmission. Improved funding conditions for banks should contribute to easing credit conditions and stimulating credit creation.

A key feature of the TLTROs is that the amount that a bank is entitled to borrow depends on its lending behaviour. Banks were entitled to an initial borrowing allowance equal to 7% of the total amount of their loans to the euro area non-financial private sector as at 30 April 2014, excluding loans to households for house purchase. Banks had the option of drawing on their initial allowance in the first two operations in September and December 2014.

Thereafter, between March 2015 and June 2016, all counterparties will have the option to borrow additional amounts in further TLTROs, depending on the evolution of their eligible lending activities in excess of bank-specific benchmarks[16]. The more banks have lent beyond the benchmark, the more they will be allowed to borrow. This incentive is amplified by the use of a multiplier, with banks being able to borrow up to three times the difference – if positive – between their net lending and the benchmark.

[16] The benchmarks are determined by taking into account each counterparty's net lending to the euro area non-financial private sector, excluding loans to households for house purchase, recorded in the 12-month period up to 30 April 2014. The Governing Council decided that for banks that exhibited positive eligible net lending in the 12-month period to 30 April 2014, the benchmarks are always set at zero, and for banks that exhibited negative eligible net lending in the year to 30 April 2014, benchmarks are set as follows: the average monthly net lending of each bank in the year to 30 April 2014 is extrapolated for 12 months until 30 April 2015, while for the year from 30 April 2015 to 30 April 2016, the benchmark monthly net lending is set at zero.

The interest rate on the TLTROs is fixed over the life of each operation. For the first two TLTROs the rate was set at the rate on the Eurosystem's MROs prevailing at the time of take-up, plus a fixed spread of 10 basis points. In order to support the effectiveness of the operations, in January 2015 the Governing Council decided to eliminate the fixed spread of 10 basis points for the TLTROs to be conducted between March 2015 and June 2016. To ensure that the funds offered to banks are used to support an increase in lending, any counterparties that do not fulfil certain conditions regarding the volume of their net lending to the real economy would be required to pay back the borrowed amounts in September 2016, two years earlier than the TLTRO maturity. All TLTROs will mature in September 2018.

The combination of low long-term refinancing rates and positive incentives to lend (as well as negative consequences for not lending) should push up loan supply, forcing lending rates down. The TLTROs are therefore designed to encourage the passing-on of favourable lending conditions related to the ECB's interest rate decisions to private sector borrowers.

The combined take-up in the first two operations was €212.4 billion (€82.6 billion in September and €129.8 billion in December). A total of 469 counterparties participated in the operations. Banks that were interested in participating but lacked the relevant loan book were allowed to team up with banks that did hold such loans by forming TLTRO groups. In this way, the operations in fact reached 1,223 credit institutions. Overall, participation was broadly based across the euro area.[17]

The borrowing allowance in the first two operations for each counterparty was calculated in advance, based on information submitted by counterparties regarding the amount of eligible loans they held on their books in April 2014. Banks submitted templates specifying their eligible loans for an amount that gave rise to an initial allowance of €266.5 billion. This compares with a theoretical allowance of about €385 billion that could have been drawn if all banks with eligible loans had submitted templates.

The TLTROs had a number of attractive features for banks. First, the price and maturity incentives embedded in the operations were, for many, favourable compared with market conditions. In particular, TLTRO funds in 2014 could be obtained at the prevailing MRO rate of 5 basis points plus a margin of 10 basis points. On the settlement day of the second TLTRO, the take-up in both operations had extended the average maturity of outstanding Eurosystem refinancing to almost one and a half years (assuming the TLTRO amounts are kept for four years), from less than four months just before the settlement of the first TLTRO. At the end of 2014 the average maturity of the operations stood slightly lower, at one year and four months. Second, banks that were less interested in participating as a result of their already comfortable funding situation reported that participation could benefit their corporate image, as they would be seen to be participating in an operation aimed at supporting the real economy. Third, by passing on the cheaper funding costs to their lending conditions, banks could improve their competitive position on the loan market.

17 For a discussion of the results of the first TLTRO, see the box entitled "The targeted longer-term refinancing operation of September 2014", *Monthly Bulletin*, ECB, October 2014.

The TLTROs contributed to the easing of financial market conditions, and the operations to be conducted between March 2015 and June 2016 will further ease the monetary policy stance and support credit creation.

Private sector asset purchase programmes aim to ease credit conditions in the economy

The two private sector asset purchase programmes – an asset-backed securities purchase programme (ABSPP) and a new covered bond purchase programme (CBPP3) – were designed to permit selective intervention in markets where the pass-through to the borrowing conditions of the non-financial private sector in the euro area is high. They therefore complement the TLTROs in addressing weak credit conditions and enhancing monetary policy transmission.

Under the ABSPP, the Eurosystem began purchasing simple and transparent asset-backed securities (ABSs) with underlying assets consisting of claims against the euro area non-financial private sector. Under CBPP3, the Eurosystem started purchasing euro-denominated covered bonds issued by MFIs domiciled in the euro area. The Governing Council announced that it expected these two asset purchase programmes to last for at least two years.

The decision to purchase simple and transparent ABSs reflects the role of this market in facilitating new credit flows to the economy. In particular, the link between the interest rate spreads at which ABSs are traded and the lending rates which banks apply on the underlying credits is tight. As the European ABS market remains impaired, the potential for interventions to change dynamics in this market is high. The Eurosystem's purchases thus strengthen the direct pass-through effect of the TLTROs, i.e. the extent to which the funding cost relief for banks is passed along to households and firms in the euro area. The reduction of spreads for ABSs creates arbitrage opportunities for banks, encouraging them to create ABSs and thereby increase loan supply, forcing lending rates down.

In respect of covered bonds the link on the issuing bank's balance sheet between the covered bond, on the one side, and the underlying loans, on the other side, is reasonably tight. As the prices for covered bonds are bid up, banks are expected to respond to the market incentives by creating more saleable covered securities, and thus more loans to collateralise them. CBPP3 therefore further complements the TLTROs and the ABS purchases. Furthermore, outright interventions in the market for covered bonds have reinforced the portfolio rebalancing channel of transmission. The expansion in liquidity resulting from the combined outright operations has promoted a diversification of investment patterns and has thereby led to an easing of financing conditions more broadly.

Implementation of asset purchase programmes under way

Under the ABSPP, the Eurosystem started its purchases on 21 November 2014 and had settled €1.7 billion of eligible securities by the end of the year (see Table 2). The purchase volumes depend on several factors, including the overall size of the market and its evolution, but also on considerations related to limiting the crowding-out of private investors from the market. The relatively limited purchase volumes during 2014 also reflect the fact that the purchases started just before the seasonal slowdown of market activity in December. However, the announcement of the ABSPP and its implementation led to a visible decline in ABS spreads, with price adjustments particularly pronounced in those market segments where the Eurosystem intervened directly.

Given the heterogeneous and broad nature of the euro area ABS market, the Governing Council considered that, in order to maximise the effectiveness of the ABSPP, it was appropriate to rely on four external asset managers, which complement each other within their respective areas of specialisation and expertise. In December 2014 the Banque de France took on the role of internal asset manager and started purchasing ABSs alongside the external asset managers. The role of the appointed asset managers is to conduct the ABS purchase transactions on explicit instructions from, and on behalf of, the Eurosystem, which undertakes price checks and due diligence prior to approving the transactions. The purchases across different segments of eligible euro area ABSs are allocated by the ECB to the different asset managers, taking into account their respective areas of specialisation. Once the Eurosystem has further developed its technical capabilities and expertise, it intends to take over the implementation of the ABSPP from the external asset managers.

Table 2
Total purchases under the ABSPP and CBPP3 in 2014

(EUR billions; percentages)

	Total amount settled in 2014	of that, share in the secondary market	of that, share in the primary market
ABSPP	1.7	90	10
CBPP3	29.6	82	18

Source: ECB.

Under CBPP3, the Eurosystem started making purchases on 20 October 2014, and the book value of bonds settled stood at €29.6 billion at the end of 2014 (see Table 2). The start of CBPP3 was smooth and effective. Purchases were made in a broad range of countries and in line with the targeted amount. The purchases are in principle conducted by the entire Eurosystem, while some specialisation has been applied for efficiency reasons. As was the case for the CBPP and CBPP2, the CBPP3 portfolio is available for securities lending. As with the ABSPP, the announcement of CBPP3 and its implementation led to a visible decline in spreads on the relevant assets.

Purchases under both programmes are conducted on both the primary and secondary markets. In 2014 18% of covered bonds and 10% of ABSs were purchased on the primary market.

The positive impact of the CBPP3 and ABSPP programmes on the respective markets was most visible directly after the announcement on 4 September and the publication of operational details on 2 October, when credit spreads tightened significantly, especially for securities issued in the more stressed jurisdictions. The start of actual purchases caused a slight further tightening, but spreads remained relatively stable thereafter. Towards the end of the year investors' demand for covered bonds weakened somewhat, owing to the relatively low spread levels, leading to a small increase in credit spreads.

For each of the two programmes, the amounts outstanding, weekly settled amounts and weekly redemptions are disclosed separately on the ECB's website and commented on in the Eurosystem's weekly financial statements. In addition, the ECB publishes information on its website with regard to the split between primary and secondary market purchases on a monthly basis for CBPP3.

Eligibility of assets for purchase programmes

Regarding the eligibility of assets for purchase, the Eurosystem collateral framework is the guiding principle, with some adjustments to take into account the difference between accepting assets as collateral and buying assets outright. To ensure that the programmes can include assets from the whole euro area, ABSs and covered bonds from Greece and Cyprus, currently not eligible as collateral for monetary policy operations, are subject to specific rules with risk-mitigating measures.[18]

In the case of CBPP3, the covered bonds need to fulfil the conditions for their acceptance as own-used collateral and some other requirements detailed in Article 2 of Decision ECB/2014/40. Entities suspended from Eurosystem credit operations are also excluded from purchases under CBPP3 for the duration of their suspension. Additionally, some limits apply to the holdings per security.

As regards the ABSPP, the securities need to fulfil the additional requirements detailed in Article 2 of Decision ECB/2014/45. In addition, the ECB conducts a credit risk assessment and due diligence in relation to such ABSs prior to their purchase and on an ongoing basis. Furthermore, some limits apply to the holdings per security.

2.3 ECB refinancing operations and liquidity developments

The Eurosystem continued to offer ample liquidity by means of the full allotment procedure in its regular refinancing operations, i.e. the main refinancing operations (MROs) and the three-month longer-term refinancing operations (LTROs). Consequently, and as in previous years since 2008, the size of outstanding refinancing operations was determined by counterparties' demand for Eurosystem liquidity. In order to continue to accommodate banks' demand for central bank liquidity, the Governing Council decided as part of the June policy package to extend the full allotment policy in MROs and LTROs at least until December 2016.

Banks continued to make substantial use of the repayment option associated with the two three-year LTROs, repaying a total amount of €334 billion in 2014, i.e. an

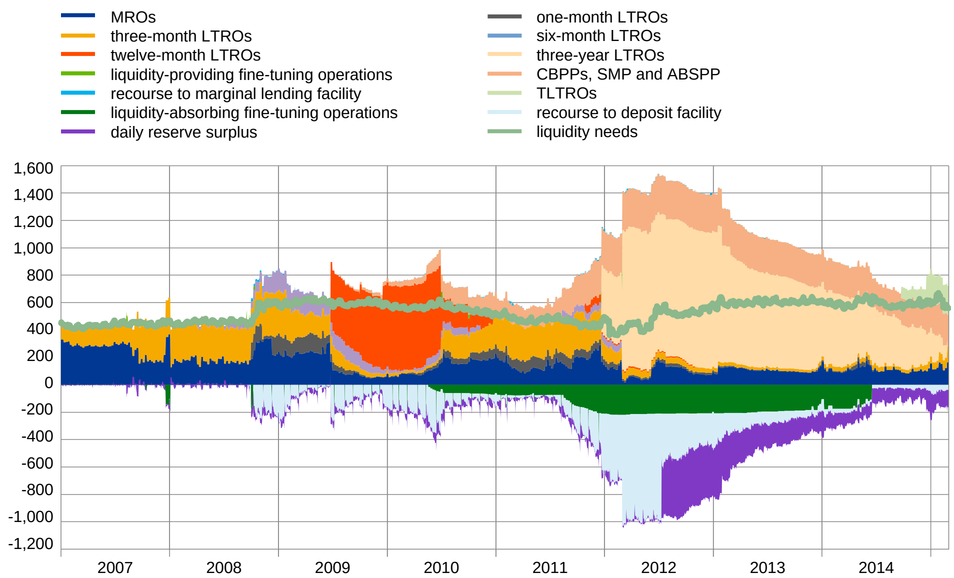
[18] For more details, see Article 2(5) of Decision ECB/2014/40 of 15 October 2014 on the implementation of the third covered bond purchase programme and Article 2(8) of Decision ECB/2014/45 of 19 November 2014 on the implementation of the asset-backed securities purchase programme.

average weekly repayment of €6.7 billion. In the context of overall rather stable liquidity needs in the strict sense, i.e. as determined by reserve requirements and autonomous factors[19], the repayments led to a gradual but substantial decline in excess liquidity and in the Eurosystem's balance sheet over the course of 2014 (see Chart 24). The repayments were motivated by various factors, including the improvement in access to funding markets and more stable sources of funding, the tendency to reduce excess reserves held for precautionary reasons, and the process of balance sheet adjustment and deleveraging. In addition, repayments may also have been supported by the decline in the regulatory value of the funding once the maturity of the three-year LTROs fell below one year. Finally, repayments were also supported by the fact that banks turned instead to shorter-term Eurosystem operations, in order to manage liquidity more actively, or to the TLTROs. Indeed, repayments spiked ahead of the two TLTRO operations: to €19.9 billion on 24 September 2014 and to €39.8 billion on 17 December 2014.

Chart 24

Eurosystem liquidity-providing and liquidity-absorbing operations since 2007

(EUR billions)



Source: ECB.

In June 2014 the weekly fine-tuning operations that had been conducted to absorb the liquidity injected by the Securities Markets Programme (SMP) were suspended. This measure, which was part of the June-October monetary policy package, led to an initial increase in the level of excess liquidity. Immediately after the suspension, excess liquidity increased to €160 billion on 18 June, from €122 billion the day before.

[19] Autonomous factors are those items on the Eurosystem's balance sheet, such as banknotes in circulation and government deposits, which have an impact on credit institutions' current account holdings, but are not under the direct control of the ECB's liquidity management function.

This increase in excess liquidity proved temporary, mainly on account of the fact that the liquidity that was no longer being absorbed by fine-tuning operations was offset by lower participation in other Eurosystem refinancing operations. Banks accelerated the repayment of three-year LTRO funds and reduced their recourse to the MROs. However, cash-rich banks that had regularly participated in the liquidity-absorbing operations could not place all of their excess funds and saw a net increase in their current account and deposit facility holdings, which limited the decrease in excess liquidity. The fact that these banks apparently did not lend their excess holdings out to other counterparties is indicative of the continued presence of market fragmentation. At the same time, liquidity needs rose owing to higher autonomous factors, which resulted in a drag on excess liquidity. By 10 July excess liquidity had returned to the levels seen just before the suspension of the weekly liquidity-absorbing fine-tuning operations.

In addition, the impact of the TLTRO allotments on liquidity provision depends on the extent to which banks change their participation in other Eurosystem credit operations settled during the same week by way of substitution. At the time of settlement, the September and December operations injected €47.9 billion and €95.3 billion in net terms respectively, as banks repaid three-year LTRO holdings and changed the amount of their participation in the relevant MRO and three-month LTRO.

Overall, participation in regular Eurosystem refinancing operations was comparable in size with that in the previous year, although somewhat more volatile. The fact that the suspension of fine-tuning operations and the launch of new operations such as the TLTROs were largely offset by three-year LTRO repayments contributed to the overall stability of the regular operations. In particular, recourse to the MROs averaged €110 billion in 2014, broadly unchanged from €108 billion in 2013. Recourse to the individual MROs fluctuated strongly between €82 billion and €174 billion in 2014. The average take-up of the three-month LTROs increased compared with the previous year, with €11 billion allotted on average, compared with €7.2 billion in 2013.

Taking all Eurosystem open market operations (excluding outright monetary policy portfolios) together, the amount of liquidity provided decreased from about €650 billion to around €600 billion at the end of 2014, even briefly dipping below €500 billion at the beginning of December (see Chart 24). This decrease was in line with the trend observed during the previous years. Consequently, excess liquidity averaged €129 billion in 2014, well below the €300 billion recorded in 2013. In the second half of 2014 the level of excess liquidity was supported by the new measures and varied from around €70 billion to €260 billion at the end of 2014. The capacity for further liquidity absorption remained high at the end of 2014, as €210 billion of three-year LTRO funding was still outstanding. However, further TLTROs and asset purchases are expected to raise the level of excess liquidity in 2015.

Protection of the Eurosystem’s balance sheet

In the implementation of monetary policy, the Eurosystem conducts credit operations with counterparties fulfilling certain eligibility criteria defined in the “General Documentation” on Eurosystem monetary policy instruments and procedures.

Although the eligibility criteria require such counterparties to be financially sound, the Eurosystem may still be exposed to the risk of unexpected counterparty defaults. This risk is mitigated by requiring counterparties to submit adequate collateral, in line with the standard practice of central banks worldwide.

In 2014 the Eurosystem continued to ensure that sufficient collateral was available to a wide set of counterparties, so that the Eurosystem could provide the appropriate amount of liquidity in its monetary policy operations.[20] Moreover, the financial risks related to liquidity-providing operations were continuously monitored and quantified at the Eurosystem level and reported to the ECB's decision-making bodies on a regular basis.

In the course of 2014 the Eurosystem adopted several measures to enhance its eligibility criteria and the risk control framework that protects it against the risk of financial loss if assets have to be realised owing to the default of a counterparty. For example, the Governing Council further refined the loan-level data requirements for ABSs. In addition, the rules for assigning the appropriate rating to determine the eligibility of marketable assets and their related haircut were modified. As regards the temporary collateral framework, the Governing Council adopted Guideline ECB/2014/31, which recasts Guideline ECB/2013/4 in the interest of clarity and allows the inclusion, in the additional credit claims framework, of certain short-term debt instruments issued by non-financial corporations that would otherwise not satisfy the Eurosystem eligibility criteria for marketable assets, provided that they comply with a number of specific criteria.

2.4 Communication on the Eurosystem's balance sheet

The Governing Council communicated that its monetary policy measures – both lending operations and asset purchases – would have a sizeable impact on the Eurosystem's balance sheet.

This communication was aimed at addressing uncertainty about the overall scale of the measures. The uncertainty arose because a key element of the June-October package – the volume of TLTROs – will largely be determined by the demand from the Eurosystem's counterparties, i.e. the decisions by individual banks to participate in the operations. Therefore, while each unit of liquidity introduced through the June-October monetary policy measures has a lasting credit-easing impact, the total amount of stimulus injected could not be anticipated precisely.

Thus, the communication on the balance sheet size reflected the Governing Council's intention to ensure that the degree of monetary stimulus would prove appropriate to raise annual HICP inflation rates to levels below, but close to, 2%. However, the size of the Eurosystem's balance sheet is not a target of monetary policy. Rather, active balance sheet management remains an instrument employed in pursuit of the ECB's price stability mandate once the effective lower bound for very short-term nominal interest rates has been reached.

20 Detailed information on eligible marketable assets as well as on the use of collateral and outstanding credit is published on the ECB's website.

3 Repair and confidence-building: the European financial sector

The ECB's activities in 2014 included its substantial contribution to strengthening the stability of and building confidence in the European financial sector. In this context, the ECB undertook a series of actions, including regularly assessing emerging risks and the resilience and shock-absorbing capacity of the financial system; analysing the links between the financial system and the economy; carrying out a comprehensive assessment of significant credit institutions; and participating in discussions on shaping the regulatory framework at both the international and EU levels. Furthermore, with the establishment of the Single Supervisory Mechanism (SSM) on 4 November 2014, the ECB formally assumed its micro- and macro-prudential tasks. This new framework will ensure that both institution-specific and systemic risks in the financial system are identified and addressed in a timely and effective manner, in close cooperation with authorities in participating Member States.

This section describes the main developments in the above areas, focusing on how the ECB's activities as well as institutional and regulatory changes contributed to the repair of the financial system, weakening the nexus between banks and sovereigns and building confidence in the EU financial sector.

3.1 Safeguarding financial stability[21] – a key task for the ECB

The ECB's financial stability analysis is regularly presented in, for example, its semi-annual Financial Stability Review.[22] The ECB also provides analytical support to the European Systemic Risk Board (ESRB) in the area of financial stability analysis. During 2014 the ECB's financial stability analysis supported in particular the development of the adverse stress-test scenarios for the EU-wide stress test of banks and insurance firms that were provided by the ESRB.[23] These scenarios were used in the EU-wide bank stress-testing exercise conducted by the European Banking Authority (EBA) on which the ECB's comprehensive assessment of banks built[24], as well as in the insurance stress test of the European Insurance and Occupational Pensions Authority (EIOPA)[25].

21 The ECB defines financial stability as a condition in which the financial system – intermediaries, markets and market infrastructures – can withstand shocks without major disruption in financial intermediation and in the effective allocation of savings to productive investment.

22 See *Financial Stability Review*, ECB, May 2014 and *Financial Stability Review*, ECB, November 2014.

23 See "EBA/SSM stress test: The macroeconomic adverse scenario" and "EIOPA/ESRB adverse financial market scenarios for insurance stress test", ESRB, April 2014.

24 See *Aggregate report on the comprehensive assessment*, ECB, October 2014.

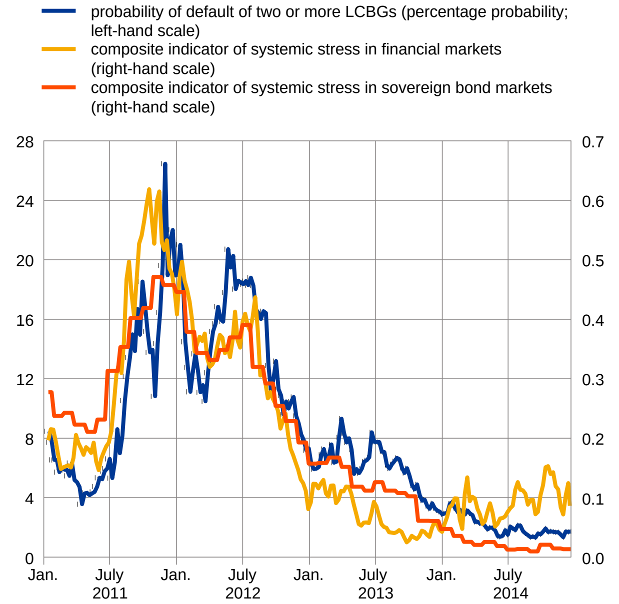
25 See *EIOPA insurance stress test 2014*, EIOPA, November 2014.

Euro area financial system stress was contained in 2014 but risks remain

Chart 25

Measures of financial market, banking sector and sovereign stress in the euro area

(January 2011 – February 2015)



Sources: Bloomberg and ECB calculations.
Notes: "Probability of default of two or more LCBGs" refers to the probability of simultaneous defaults in the sample of 15 large and complex banking groups over a one-year horizon. For more information on composite indicators of systemic stress, see Hollo, D., Kremer, M. and Lo Duca, M., "CISS – a composite indicator of systemic stress in the financial system", *Working Paper Series*, No 1426, ECB, March 2012.

Financial system stress in the euro area remained contained throughout 2014. Indicators of stress among euro area banks and sovereigns declined further to levels last seen before the outbreak of the global financial crisis. Stress across the broader financial system also remained contained (see Chart 25).

The financial stability risks faced by the euro area during 2014 can be divided into two broad categories. First, "legacy" issues from the global financial crisis, while receding throughout the year, remained a concern. For the euro area, these mainly related to insufficient progress in addressing weaknesses on the part of both the banking sector and governments. The second broad set of risks were "emerging" risks, which mainly stemmed from a continued global search for yield. This left the financial system more vulnerable to an abrupt reversal of risk premia.

Underlying all of the key risks to financial system stability was the uncertainty owing to the weak, fragile and uneven economic recovery. The very low rate of inflation also has the potential to aggravate existing vulnerabilities, should it remain at current levels for longer than expected or decline further.

Continued progress in resolving legacy issues from the global financial crisis

Both banks and governments continued to take action in 2014 to address legacy risks from the crisis. Euro area bank balance sheets were strengthened further in the course of the year, with a clear shift towards capital increases – related to the comprehensive assessment carried out by the ECB – from deleveraging and de-risking in previous years. At the same time, progress by euro area governments in implementing fiscal consolidation and structural reforms continued, although the pace was uneven across countries. The improved sentiment resulted in significantly declining yields on lower-rated euro area government bonds, which in some cases reached levels last seen before the eruption of the euro area-centred second wave of the global financial crisis in 2010.

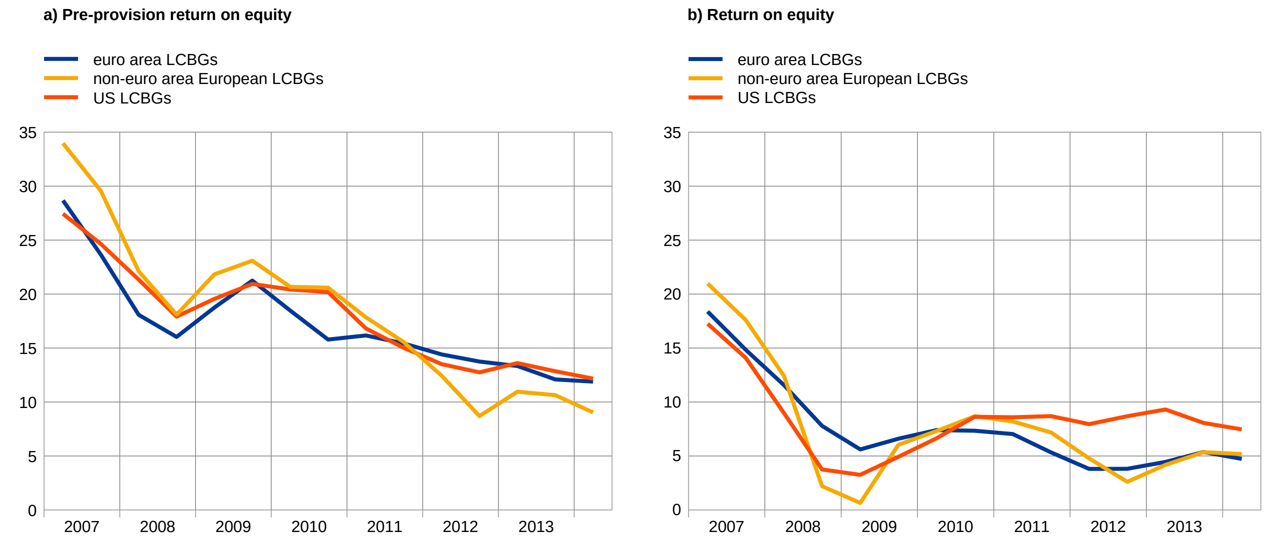
Despite this progress by both banks and governments, financial stability challenges persist. While the comprehensive assessment ensured that significant banks in the euro area have sufficient capital levels, the banking system needs to address remaining fragilities and uncertainties. The main challenge facing the euro area banking sector during 2014 was continued low profitability levels in large parts of the sector, which stemmed mainly from the weak economic environment. Persistently weak bank profitability could become a systemic concern if it limits banks' ability to improve their shock-absorbing capacity via retained earnings and provisioning. This could prevent banks from engaging in new profitable lending activities and lead to more structural business model-related concerns in a low growth environment. In such circumstances, banks might be tempted to take on more risk to improve profitability, which in turn could make them more vulnerable to future shocks.

Banks' return on equity during 2014 stood well below their cost of equity (shareholders' expected rate of return), which also points to a structural need for further balance sheet adjustment in parts of the banking system. Sluggish bank profitability was, however, a challenge that affected not only euro area banks during 2014. Their aggregate financial performance closely resembled that of non-euro area European banks and – once loan loss provisioning is corrected for – also that of their US peers (see Chart 26).

Chart 26

Pre- and post-provision return on equity of euro area and global large and complex banking groups

(percentages; medians; two-period moving average)



Sources: SNL Financial and ECB calculations.
Notes: "Non-euro area European LCBGs" includes banks from the United Kingdom, Switzerland, Sweden and Denmark. Data are for the period from the first half of 2007 to the first half of 2014.

Sovereign debt-related stress remained contained in the euro area during 2014. Supported by the improved sovereign debt market conditions following the announcement of Outright Monetary Transactions in 2012 and the ECB's policy action during 2014, market sentiment remained relatively favourable. The gradual strengthening of cyclical economic conditions and the ongoing fiscal consolidation underpinned this development.

Sentiment was also supported by continued progress in weakening the links between sovereigns and banks. The establishment of the SSM and regulatory initiatives – such as new bail-in rules – were crucial in this respect. However, the continued significant correlation between the borrowing costs of euro area banks and sovereigns highlights the need for continued progress.

Chart 27
Price-based Financial Integration Composite (FINTEC) for the euro area

(January 1999 – December 2014)

Sources: ECB and ECB calculations.
Notes: The "price-based FINTEC" (Financial INTEgration Composite) aggregates the information from a selection of existing price-dispersion indicators that cover the four financial market segments of interest. The FINTEC is bounded between zero (full fragmentation) and one (full integration). Increases in the FINTEC signal higher financial integration. For further details, see *Financial integration in Europe*, ECB, 2015, forthcoming.

Public debt sustainability challenges persisted in 2014 owing to continued high debt levels in many countries, heightened downside risks to the economic outlook and a very low inflation environment. Uncertainties relating to the sustainability of sovereign debt are likely to remain a key issue. This highlights the need for further adjustment of the fiscal and economic fundamentals that are relevant for debt sustainability.

Supported by the progress made by banks and sovereigns in tackling legacy problems from the global financial crisis, the increase in euro area financial market integration witnessed since 2012 continued throughout 2014, reaching levels last seen before the onset of the euro area sovereign debt crisis (see Chart 27).[26] Improvements in the state of financial market integration were registered to varying degrees in all key market segments – money, bond, equity and banking markets.

In the money market, integration continued to increase at a gradual pace amid sustained action by banks to reduce balance sheet uncertainties and improve funding positions. This improvement was reflected in declining levels of excess liquidity – the amount of cash held by banks above usual requirements.

Fragmentation also receded further in euro area bond markets during 2014. The improvement in bond market integration was the result of several factors. First, the disparity in economic sentiment across euro area countries declined further. Second, the ECB's decisions on further monetary policy measures underpinned confidence throughout the year. Third, the monetary policy stance across other major currency areas remained accommodative overall, which contributed to a search for higher-yielding assets. This drove down the spreads of riskier assets and contributed to lower fragmentation in euro area bond markets. These factors also supported stock markets, where the degree of cross-country heterogeneity declined somewhat further in 2014 in the euro area.

The integration of euro area banking markets improved somewhat during 2014 with regard to lending activity and the gathering of deposits. Cross-border banking activity increased moderately, although the level of integration in banking markets remained lower than before the onset of the financial crisis. This was illustrated, for example, by the persistent gap between the borrowing costs paid by non-financial corporations – particularly small and medium-sized enterprises – across euro area countries, which has not yet closed.

While the Eurosystem considers financial market integration to be first and foremost a market-driven process, the legislative and regulatory framework for the financial system clearly plays an important facilitating role. Numerous important achievements

26 For a more detailed analysis of financial market integration developments during 2014, see *Financial integration in Europe*, ECB, 2015, forthcoming.

in the regulatory realm during 2014 supported financial market integration (see also Sections 3.3 and 3.4 of this chapter). The ECB assumed responsibility for banking supervision on 4 November 2014. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are essential pillars of a more robust and resilient framework to help prevent future financial crises as well as to ensure effective intervention and, ultimately, the resolution of banks if needed. This will contribute significantly to the integration of European financial markets.

Emerging risks needed close monitoring and analysis

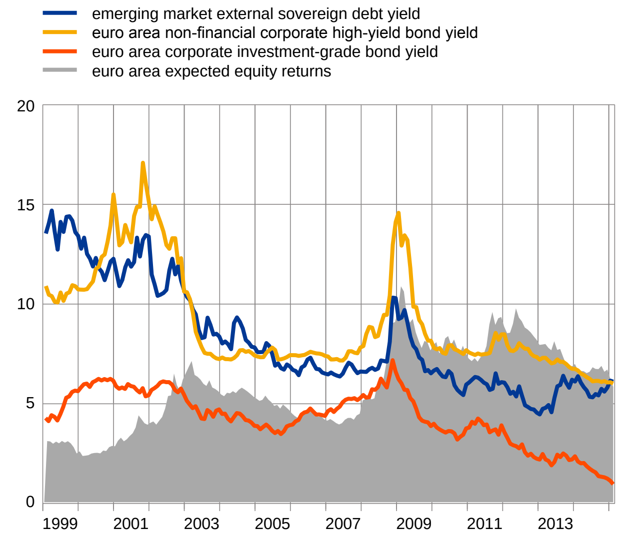
While prevailing financial stability challenges were to a large extent linked to legacy issues stemming from the financial crisis, signs of new potential risks emerged thereafter and in some cases gathered further momentum in 2014. These risks were largely linked to the low interest rate environment, which contributed to a search for yield in financial asset markets as well as in some real asset markets, where low borrowing costs fuelled price increases in some segments and countries.

Despite bouts of volatility – linked to rising geopolitical tensions and weak economic data – a search for yield persisted during 2014 across global financial markets, which in Europe was most visible in corporate and government bond markets (see Chart 28). This was associated with an increased correlation within and across euro area bond, equity and money markets reminiscent of the years before the onset of the global financial crisis.

Chart 28

Selected bond yields and euro area expected equity returns

(January 1999 – February 2015; percentages)



Sources: Bloomberg, Bank of America/Merrill Lynch indices, R. Shiller (Yale University), ECB and ECB calculations.
Note: The euro area expected equity return is the inverted Shiller cyclically adjusted price/earnings ratio.

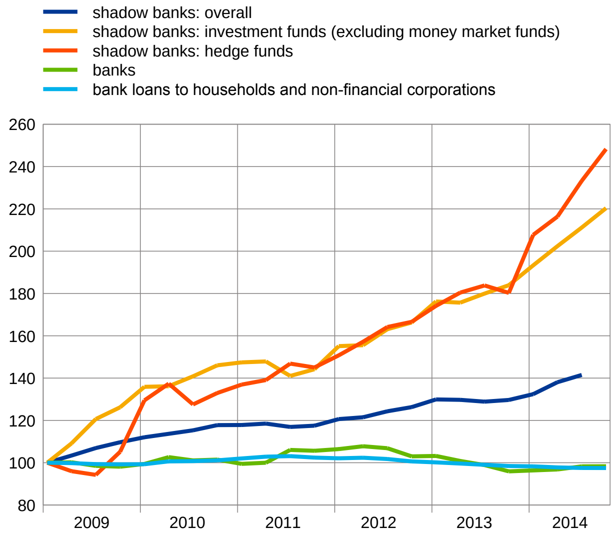
The steady growth of euro area non-bank credit intermediation (which is considered by the Financial Stability Board to be a broad definition of, or proxy for, shadow banking, and includes all non-monetary financial institutions except insurance firms and pension funds) in recent years suggests that vulnerabilities are likely to have increased in this area (see Chart 29).[27] The euro area shadow banking sector has expanded substantially over the past decade. The broadest measure of shadow banking shows that total assets doubled to reach €22 trillion in June 2014. Important changes have taken place within the sector that can be linked to three by-products of the financial crisis. First, the very low interest rate environment has created challenges for money market funds, the assets of which shrank from a pre-crisis peak of €1.3 trillion to €835 billion in mid-2014. Second, the assets of financial vehicle corporations involved in securitisations located in the euro area shrank by almost a third, to €1.9 trillion,

[27] The Financial Stability Board defines shadow banking as “credit intermediation involving entities and activities (fully or partially) outside the regular banking system”. For a discussion on the euro area shadow banking sector, see Doyle, N., Hermans, L., Mikkonen, K. and Molitor, P., “Structural features of the wider euro area financial sector”, *Banking Structures Report*, ECB, October 2014.

Chart 29

Assets of selected euro area financial sectors

(Q1 2009 – Q4 2014; index: Q1 2009 = 100)



Sources: ECB and ECB calculations.

over the same period. Third, the decline in money market funds and financial vehicle corporations has been more than offset by the strong growth of the euro area investment fund sector (excluding money market funds). Against the backdrop of an intense global search for yield, the euro area investment fund sector (excluding money market funds) grew to €8.9 trillion in the third quarter of 2014.

Shadow banking entities have become an important provider of credit to the euro area economy, especially as bank credit has contracted in recent years. Any problem confronting shadow banking entities could therefore propagate quickly to the banking sector and the real economy, since these entities are highly interconnected with euro area credit institutions. They are also an important source of funding for euro area banks, non-financial corporations and governments. Although the provision of banking services by such entities can have a number of benefits, such as increasing the real economy's access to credit, supporting market liquidity and enabling the sharing of risk, further initiatives are needed to monitor and assess vulnerabilities in the growing shadow banking sector. At the same time, continued efforts are needed to improve macro-prudential oversight and the policy tools available for mitigating action, as those that are currently available provide limited scope to deal with risks stemming from shadow banking activities.

3.2 The ECB's macro-prudential function

The ECB and the ESRB both exercise macro-prudential policy functions, each in the remit of their respective mandates and in close cooperation with one another.

Macro-prudential policy and regulation

With the establishment of the SSM, the ECB assumed its macro-prudential tasks, meaning that it can apply, on its own initiative and subject to coordination with national authorities, measures that are defined in the relevant EU legislation. This notwithstanding, it is worth highlighting that the primary responsibility for the implementation of macro-prudential measures lies with the national competent or designated authorities. The ECB can apply higher requirements for capital buffers and more stringent measures than those applied by the national competent or designated authorities (see Article 5 of the SSM Regulation).

In view of the ECB's new micro- and macro-prudential functions, an internal mechanism has been set up to foster ex ante coordination on macro-prudential matters and key policy issues in prudential and financial regulation. Coordination mechanisms between the ECB and the national competent or designated authorities of participating Member States have also been established.

The macro-prudential toolkit includes capital buffers as well as other measures defined in the Capital Requirements Regulation and the fourth Capital Requirements Directive (CRR/CRD IV package), such as additional disclosure requirements, large exposure limits, risk weights for real estate and measures related to intra-financial sector exposures.

However, the current CRR/CRD IV package does not include certain measures which could also effectively address specific types of systemic risk and may therefore be amended at a later stage. Additional measures could, for example, include (i) various asset-side measures, such as the application of limits to loan-to-value, loan-to-income or debt service-to-income ratios, and (ii) the introduction of various exposure limits falling outside the current definition of large exposures. It should be noted that the CRR/CRD IV already envisages the possibility to impose specific requirements to address systemic liquidity risks as well as to apply stricter rules concerning liquidity requirements to address macro-prudential or systemic risk. Furthermore, the CRR provides for the possible introduction of a leverage ratio subject to a legislative proposal. In addition, the macro-prudential framework should include instruments to address risks relating to or stemming from non-banks.

Further potential challenges to macro-prudential policy at the SSM level include a lack of harmonisation with regard to some instruments and the unavailability of certain tools in some countries. In addition, the assessment by authorities of the potential cross-border impact of national measures has been rather limited, although work on the matter has been carried out by the ESRB. In order to strengthen the effectiveness of macro-prudential policies, it would thus be beneficial to further reflect on whether and how to extend the application of such measures across borders. In addition, the supervisory colleges and the ESRB provide additional possibilities for information exchange and coordination with non-euro area countries.

The ECB has established a process for information exchange and coordination among national authorities and with the ECB that facilitates the implementation of various instruments and the assessment of their cross-border implications. These include early discussion and coordination of planned policy measures. The SSM Framework Regulation, which implements the SSM Regulation, states that if a national authority intends to make use of a macro-prudential tool, it must inform the ECB as early as possible. A corresponding obligation towards national authorities falls upon the ECB if it intends to make use of its powers to apply higher requirements. This framework is complemented by regular assessments by the ECB and an in-depth discussion of risks and policy tools with countries where systemic risks have been identified.

Macro-prudential policy and regulation at the EU level: cooperation with the ESRB

The ECB continued to cooperate closely with the European Systemic Risk Board (ESRB), which is entrusted with overseeing the EU financial system as a whole. The main objective of the ESRB is to prevent and mitigate systemic risks (both cyclical and structural) to financial stability in all financial sub-sectors. It brings together representatives of the ECB, the NCBs and national supervisory authorities of the EU Member States, the European Supervisory Authorities (ESAs), the European Commission and the Economic and Financial Committee. The ECB continued to provide analytical, statistical, logistical and administrative support to the ESRB Secretariat, which is responsible for coordinating the day-to-day business of the ESRB.

In 2014 the ESRB focused on the identification of potential systemic risks in the form of: (i) global financial market repricing, (ii) macroeconomic risk, (iii) fragilities in banks' and insurance companies' balance sheets, (iv) sovereign issues, and (v) market structures. It also examined a number of new issues, such as over-banking, loan origination by investment funds, and the regulatory treatment of sovereign exposures, and contributed to the design of the stress-test scenarios for both banks and insurance firms.

Given its coordinating function as regards the use of CRR/CRD IV-based macro-prudential instruments, the ESRB discussed a large number of national macro-prudential measures during 2014, taking into account in particular the cross-border effects of these measures. The ESRB also published a broad set of guidelines on the use of these instruments and continued to assess the implementation of its Recommendation on the macro-prudential mandate of national authorities, with a view to further strengthening the macro-prudential framework.

Box 5

Comprehensive assessment

The comprehensive assessment of banks expected to qualify as significant was a prudential exercise of unprecedented scope and depth and marked a crucial milestone in setting up the SSM. The wealth of in-depth information gathered on the banks subject to direct ECB supervision in this exercise serves as an important input for their ongoing supervision.

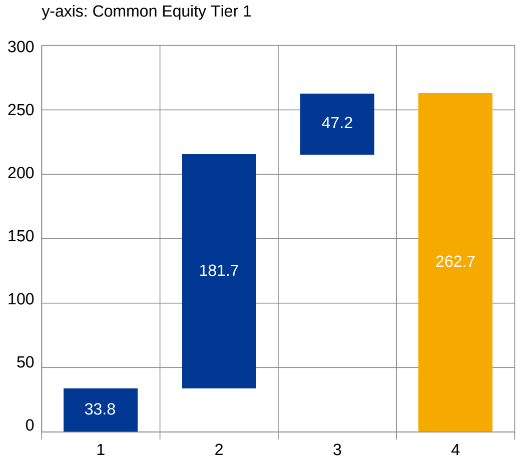
The comprehensive assessment began in autumn 2013 and was finalised with the publication of results on 26 October 2014. The exercise consisted of an asset quality review (AQR) and a stress test, with three main objectives: (i) to establish transparency by enhancing the quality of information available on the condition of banks; (ii) to identify and implement corrective actions if and where needed; and (iii) to build confidence by assuring all stakeholders that banks are fundamentally sound and trustworthy. The AQR was a point-in-time assessment of the accuracy of the carrying value of assets on banks' balance sheets as at 31 December 2013 and provided a starting point for the stress test. The stress test provided a forward-looking examination of the resilience of banks' solvency to two hypothetical scenarios, also reflecting new information arising from the AQR.

Overall, the comprehensive assessment identified a capital shortfall of €24.6 billion across 25 participating banks[28] after comparing the projected solvency ratios with the thresholds defined for the exercise. Between 1 January and 30 September 2014 participating banks raised a total of €57.1 billion in capital. After such capital measures were accounted for, the shortfall was reduced to €9.5 billion distributed across 13 banks.

Chart A

Comprehensive assessment adverse scenario capital depletion

(SSM bank sample; EUR billions)



1 AQR adjustment net of tax offset
2 Reduction in available capital from stress test
3 Additional required capital due to increase in risk-weighted assets
4 Adverse scenario capital depletion plus the effect on required capital

Sources: ECB and ECB calculations.

Under the adverse scenario, the stress test led to a total capital depletion of €181.7 billion, and the increase in risk-weighted assets resulted in additional capital requirements of €47.2 billion. Together with the net AQR adjustment of €33.8 billion, this implies a total figure of €262.7 billion (see Chart A).

These results are testimony to the fact that the adverse scenario developed by the ESRB was the most severe scenario of all EU-wide stress tests conducted so far. The macro-financial stress covered three years, not two as in previous exercises, which added to its relative severity.

Looking at the market reaction to the results of the comprehensive assessment, developments in bank shares across Europe showed a high degree of heterogeneity, depending on the country of residence of the banks concerned. Overall, it can be argued that markets reflected the results of the comprehensive assessment in an adequate manner, by appropriately differentiating between institutions.

The comprehensive assessment succeeded in substantially increasing the level of transparency of banks' balance sheets through the publication of bank-level results in very granular disclosure templates. The requirement for banks facing capital shortfalls to make up those shortfalls within six or nine months, depending on the source of the shortfall, constitutes a strong driver for the process of balance sheet repair. The implementation of the remedial capital plans submitted by these banks is being monitored by the relevant Joint Supervisory Teams. The corresponding capital actions will result in increased solvency levels and thus enhance the stability of individual banks and the system as a whole.

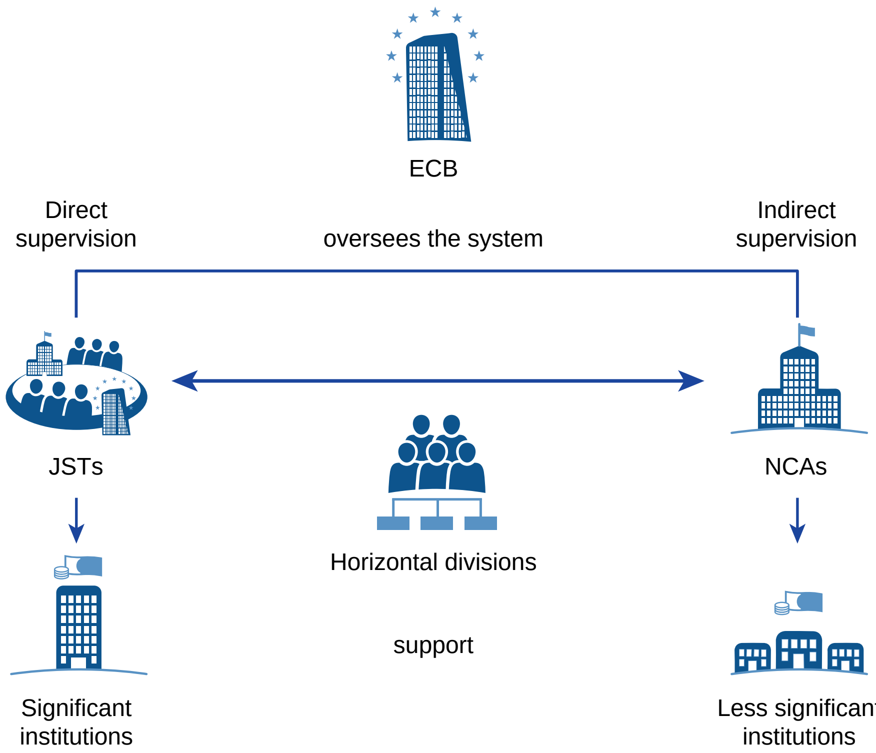
All of this contributes to enhancing the confidence of all stakeholders in the fundamental soundness of the euro area banking system. However, the stress test cannot – and was not intended to – replace the day-to-day supervision that is now being conducted by the SSM, taking due account of bank-specific situations as well as of ongoing developments.

[28] These include two banks which are implementing restructuring plans agreed with the European Commission, under which one bank would have a zero shortfall and the other would have a small shortfall.

3.3 The ECB's micro-prudential activities

One year after the entry into force of the SSM Regulation, the ECB formally took on its supervisory tasks on 4 November 2014. Together with the national competent authorities (NCAs), the ECB will contribute to the safety and soundness of the banking system and the stability of the financial system. The start of the SSM followed months of highly intensive preparatory work, including the establishment of the SSM governance structures, the finalisation of the legal framework for SSM supervision, the organisational development and staffing of the ECB's supervisory function, and the development of the SSM supervisory model. In parallel, the ECB carried out a comprehensive assessment of significant banks, subjecting them to an in-depth asset quality review and a stress test (see Box 5 for details).

The distribution of tasks within the SSM



ECB/SSM preparations – getting ready for banking supervision

In line with the SSM Regulation, the planning and execution of the tasks conferred on the ECB are fully undertaken by the Supervisory Board as an internal body of the ECB. The Supervisory Board takes draft supervisory decisions which are deemed adopted unless the Governing Council, as the ultimate decision-making body of the ECB, objects within a defined period of time. The establishment of the Supervisory Board, including the appointment of the Chair, Vice-Chair and three ECB representatives in late December 2013 and early 2014, was thus a key step in setting up the governance structures of the SSM.[29] The Supervisory Board has been operational since January 2014, meeting on a regular basis to discuss and prepare decisions on key matters related to the SSM. The establishment of the Steering Committee of the Supervisory Board, as well as the Administrative Board of Review and the Mediation Panel, were further important steps in completing the SSM governance framework. The mandate of the Administrative Board of Review is to review supervisory decisions if a request is submitted by any natural or legal person. The purpose of the Mediation Panel is to resolve – if so requested by an NCA – differences of views regarding an objection by the Governing Council to a draft decision prepared by the Supervisory Board. For details on the measures taken to ensure the separation between the monetary policy and supervisory functions of the ECB, see Section 6 of Chapter 2.

The completion of the legal framework for SSM supervision required the adoption of the SSM Framework Regulation, setting out the practical arrangements for the implementation of Article 6 of the SSM Regulation (concerning the cooperation between the ECB and the NCAs within the SSM), as well as the ECB Regulation on supervisory fees. The former was published in April 2014, the latter in October 2014. Both regulations were subject to a public consultation before their finalisation.

As regards the operational set-up of the ECB's supervisory function, the establishment of the Joint Supervisory Teams (JSTs), which are composed of ECB and NCA staff and are entrusted with the direct supervision of significant institutions, was a crucial step. A JST has been created for each significant institution. The organisational set-up of the indirect supervision of less significant institutions and the horizontal and specialised functions was further developed. Recruitment efforts for all SSM business areas of the ECB were enormous; overall, more than 960 staff out of an approximate total of 1,000 budgeted positions had been recruited by the beginning of January 2015.

Another key aspect of the SSM preparations was the development of the SSM Supervisory Manual, which establishes the processes and methodology for the supervision of credit institutions and the procedures for cooperation within the SSM and with authorities outside the SSM.The manual is a "living document" that is updated to reflect new market developments and supervisory practices.

In order to facilitate the exchange of information and ensure the best possible coordination within the SSM, various fora have been established. Several existing ESCB/Eurosystem committees now meet in an SSM composition to deal with aspects of banking supervision in their respective areas of responsibility. Where appropriate ESCB/Eurosystem committees did not exist, networks of experts have been established comprising experts from both the ECB and the NCAs.

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29 According to Article 26(1) of the SSM Regulation, the Supervisory Board must include four representatives of the ECB. The fourth representative was appointed in February 2015.

The way forward for the ECB/SSM – harmonisation to ensure the highest supervisory standards

Ongoing supervision by the JSTs addresses a variety of issues that constitute important challenges for the supervised institutions. In particular, the SSM sets supervisory priorities which build upon the identification of the main risks with the potential to threaten the SSM banking system as a whole. At a general level, this includes the assessment of the profitability and sustainability of the specific business model of each bank in a low interest rate environment, as well as of the institutions' governance and risk management processes and the transition to higher capital requirements required by the CRR/CRD IV.

SSM supervisors use the full range of supervisory tools at their disposal to monitor these issues and induce corrective actions by the institutions where required. The Supervisory Review and Evaluation Process is a key instrument in this respect. It is conducted on an annual basis, with the key purpose of ensuring that institutions' capital and liquidity, as well as their internal arrangements, strategies and processes, are adequate to ensure the sound management and coverage of their risks. In addition, this ongoing assessment may result in the need to issue recommendations and adopt supervisory measures.

In all its activities, the establishment of a level playing field in the supervisory and regulatory treatment of institutions across all Member States is an important goal for the SSM. Specific horizontal and specialised functions at the ECB are tasked with (i) fostering the harmonisation of supervisory approaches; (ii) promoting an intrusive approach to banking supervision; and (iii) intensifying cooperation and communication inside and outside the SSM.

Significant efforts are being made to drive forward harmonisation in areas where national rules and practices diverge. These efforts involve taking stock of existing national supervisory practices, developing standards, testing and further refining harmonised supervisory methodologies, conducting quality assurance reviews and measuring the effectiveness of actions implemented.

Such efforts are not limited to the significant institutions under direct ECB supervision. The ECB also exercises indirect supervision of less significant institutions. In 2015 it will aim to finalise the design and set-up of its supervisory approach. This involves issuing guidelines and regulations to NCAs, conducting thematic reviews, organising staff exchanges and participating in crisis management, all in close cooperation with the NCAs.

Harmonisation across the SSM is pursued with the objective of converging towards best practices and the highest supervisory standards in all areas, ensuring the SSM's contribution to enhancing the stability of the euro area banking system and rebuilding confidence in this system.

3.4 EU efforts to break the nexus between banks and sovereigns

Significant progress towards establishing a banking union was made in 2014. In parallel to the establishment of the SSM and the development of the single rulebook, the Eurosystem contributed to the preparatory work on the Single Resolution Mechanism (SRM), including the Single Resolution Fund (SRF). Together, the SSM, the single rulebook, the SRM and the SRF are essential pillars of a more robust and resilient framework to help prevent future financial crises and to ensure effective intervention and, ultimately, the resolution of banks in the event of a bank failure.

During the recent crisis, the lack of a common resolution framework obliging investors (i.e. shareholders and creditors) to bear losses contributed to a nexus between banks and sovereigns. The existence of implicit and explicit state guarantees during the crisis had serious consequences in the form of increased fragmentation of the Single Market. One key objective of the banking union, and in particular of the SRM, is to break this link between banks and sovereigns by making efficient resolution a common attainable objective while simultaneously reducing the need for costly public intervention. The banking union will contribute to the integration of European financial markets and will be instrumental in the efforts to efficiently manage future financial crises and to break the harmful nexus between banks and sovereigns.

The Bank Recovery and Resolution Directive complements EU state aid rules

During the financial crisis, the EU state aid guidelines and communications provided the framework for coordinated action in support of the financial sector. The framework sets out not only the conditions for access to state aid for the financial sector, but also the way in which restructuring plans are assessed and the minimum rules for burden-sharing with capital holders and junior creditors of distressed banks accessing public support. It also ensures that state aid and distortions of competition between banks and across Member States are kept to a minimum. In an environment where Member States had their own individual crisis management and resolution regimes in place, this framework created a minimum level of harmonisation for crisis management and resolution in the EU. However, it was clear that a single rulebook for the recovery and resolution of banks and large investment firms was needed, which would both harmonise and upgrade the powers and tools needed for effectively dealing with bank crises across the EU.

As of 1 January 2015 the Bank Recovery and Resolution Directive (BRRD) has to be implemented by all Member States.[30] The BRRD establishes common and

30 The BRRD entered into force on 2 July 2014. Member States had to transpose the BRRD into national legislation by 31 December 2014, and to apply it as of 1 January 2015. However, the bail-in provisions will only be applicable as of 1 January 2016.

efficient tools and powers to address a banking crisis pre-emptively and to manage the failure of credit institutions and investment firms in an orderly manner throughout the EU. In particular, the BRRD lays out a comprehensive set of measures which ensure that banks and authorities make adequate preparations for crises and that national authorities are equipped with the necessary tools to intervene in a troubled institution at a sufficiently early stage. In addition, it allows national authorities to have harmonised resolution tools and powers to take rapid and effective action when a bank is deemed to be failing or likely to fail, and to cooperate effectively when dealing with the failure of a cross-border bank.

One of the key objectives of the BRRD is to shift the cost of bank failures from the taxpayer to the shareholders and creditors of a failing bank, and the banking sector at large, via banks' contributions to the resolution fund. This is important for many reasons, not least that of solving the too-big-to-fail problem of large banks, which – unless there is a credible resolution option – risk having to be bailed out by the taxpayers at huge cost during financial crises. These banks have often been perceived by markets as having an implicit state guarantee, which creates not only a moral hazard problem, but also an uneven playing field among banks. For example, the fact that large banks are expected to be saved by the state means that large banks in fiscally strong countries can fund themselves far more cheaply than smaller banks or banks in countries with weaker public finances. The introduction of a credible resolution framework thus contributes to breaking the link between banks and their sovereigns, which proved to be both costly and destabilising during the recent crisis. An important tool for attaining this objective is the bail-in tool, which enables the resolution authority to write down, or convert into equity, the claims of a broad range of creditors. This will ensure that shareholders and creditors first and foremost bear the losses and the costs of bank resolution.

Finally, the BRRD is fully in line with the recommendations of the Financial Stability Board on effective resolution regimes for financial institutions[31] as well as with ongoing work to develop policy proposals on how legal certainty in respect of the cross-border recognition of resolution measures can be ensured. It delivers a comprehensive resolution toolkit that ensures that any bank failure is dealt with in an orderly manner, minimising the burden on taxpayers.

The Single Resolution Mechanism - breaking the link between banks and their sovereigns

Since 1 January 2015 the SSM has been complemented by the Single Resolution Mechanism (SRM) for all countries participating in the SSM.[32] The levels of responsibility and decision-making for supervision and resolution will be aligned on the basis of harmonised underlying legal frameworks, such as the BRRD, eliminating

[31] See *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Financial Stability Board, published in October 2011 and updated on 15 October 2014.

[32] While the preparatory work including the operation of the Board and the preparation of resolution plans and resolvability assessments apply from 1 January 2015, the SRM Regulation will be applicable only from 1 January 2016 as regards resolution powers.

the previous institutional fragmentation. This will further contribute to dissolving the link between banks and their sovereigns and therefore also help to open up the market for bank debt across Europe.

The SRM consists of the national resolution authorities with a Single Resolution Board (SRB) at its centre. The SRB is a fully independent agency of the EU, financed by contributions from the banking sector. It has a Chair, a Vice-Chair and four further permanent members, and may also involve, as the case may be, the European Commission, the ECB and the national resolution authorities of the participating Member States. The European Commission and the ECB have the status of permanent observers, while the SRB may invite other observers on an ad hoc basis. The SRB is expected to be fully operational from 2016, when the Single Resolution Fund is established. The SRB will then have full access to the set of resolution powers endowed by the SRM Regulation, including the management of the Single Resolution Fund. However, in 2015 the SRB will already be collecting information and cooperating with the national resolution authorities and other competent authorities, including the ECB, in preparation for its subsequent work.

The Single Resolution Fund – preparatory work completed

An important element of the SRM will be the establishment of the Single Resolution Fund (SRF) in 2016. Although the SRF is established by the SRM Regulation, certain elements related to the functioning of the SRF are regulated in an intergovernmental agreement between the participating Member States.[33] This agreement provides the legal foundations in line with national constitutional provisions for mutualising SRF funds. The scope of the agreement is mainly focused on arrangements to cover the period when the SRF is being built up. During this transitional period of eight years, the SRF will be composed of national compartments, which are to be progressively mutualised by the end of the transitional period. The agreement therefore covers: (i) the transfer of the contributions raised by the national resolution authorities to the national compartments; (ii) the frontloaded mutualisation of the funds available in the national compartments; (iii) the order in which financial resources are mobilised for fund resolution from the compartments and other sources; (iv) the replenishment of the compartments if needed; and (v) the temporary lending between national compartments if needed. It also includes provisions which apply in the event of the participation of non-euro area countries in the SRM via close cooperation within the SSM.

The target size of the SRF, which is set at 1% of the covered deposits of all banks in participating countries, should be reached within eight years. The precise amount that an individual bank will contribute is determined by Commission Delegated Regulation (EU) 2015/63 and Council Implementing Regulation (EU) 2015/81. The individual contributions will be based on: (i) a fixed component, which is based on the relative size of an institution’s liabilities (excluding own funds and covered

[33] Representatives of all EU Member States except Sweden and the United Kingdom signed the intergovernmental agreement. Member States that have signed but do not participate in the SSM will only be subject to the rights and obligations stemming from the agreement once they participate in the SSM.

Table 3
Distribution of contributions to the SRF

(percentages)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
BRRD fee	60	40	33.3	26.7	20	13.3	6.7	0
SRM fee	40	60	66.7	73.3	80	86.7	93.3	100

Source: Council Implementing Regulation (EU) 2015/81 of 19 December 2014.

deposits with respect to the aggregate liabilities of all institutions authorised in the participating countries); and (ii) a risk adjustment, in accordance with the risk profile of each institution. The establishment of the SRF will entail a gradual shift from a national to a European target level of the resolution fund, which implies that national banking sectors may have to contribute more or less to the SRF than they would to a national resolution fund under the BRRD. In order to prevent abrupt changes, the Council Implementing Regulation provides for an adjustment mechanism to mitigate these effects during the transitional period. This is accomplished by way of a non-linear phasing-in of the contributions calculated on the basis of a single target level and a non-linear phasing-out of the contributions calculated on the basis of national target levels in accordance with the BRRD (see Table 3).

European Stability Mechanism, backstops and borrowing capacity of the SRF

Ensuring effective and sufficient financing of the SRF is of paramount importance to the credibility of the SRM. Given that situations may arise in which the means available in the SRF are not sufficient and the ex post contributions that can be raised in order to cover the shortfall are not immediately accessible, ways of dealing with such cases need to be developed. The SRM Regulation specifies that the capacity of the SRB to contract alternative funding means for the SRF should be enhanced in a manner that optimises the cost of funding and preserves the creditworthiness of the SRF. Concrete and meaningful steps are needed in 2015 to make progress in this field.

In addition, a common backstop to the SRF will be developed before the end of the eight-year transitional period of the SRF. This backstop will also facilitate borrowing by the SRF. Meanwhile, in order to ensure continuous sufficient financing during the transitional period, the intergovernmental agreement specifies that the countries affected by a particular resolution action should provide bridge financing from national sources or, if needed, the European Stability Mechanism in line with agreed procedures.

Cooperation between the SRM and the SSM

Cooperation within the banking union is a key priority. The EU crisis management framework creates a duty for supervisory and resolution authorities to cooperate. The interaction between the SSM and the SRM is structured around three main pillars: complementary institutional roles, cooperation and strong coordination.

From an institutional perspective, it is worth noting that supervision and resolution are two building blocks of banking union. The SSM and the SRM thus have complementary roles to play in the success of the banking union.

To ensure that they play these roles, the SSM and the SRM will need to cooperate closely in order to ensure that the overall supervisory and resolution framework and any overlaps are effectively managed. The ECB has designated a representative entitled to participate, as a permanent observer, in the meetings of executive sessions and plenary sessions of the SRB. This representative will be entitled to participate in the debates and will have access to all documents. In the same vein, the ECB may invite the Chair of the SRB to participate as an observer in the Supervisory Board of the ECB.

Structural reform of the banking sector – preventing banks from directly engaging in high-risk proprietary trading

The banking union project is to be complemented by structural reform of the EU banking sector. On 29 January 2014 the European Commission adopted a legislative proposal that focuses on European banks that are identified as being of global systemic importance and those that exceed certain thresholds. The proposal involves a ban on proprietary trading as narrowly defined, with the exception of those activities involving financial instruments issued by EU governments and cash management activities. Furthermore, it suggested the potential separation of certain trading activities, namely market-making, complex securitisation and complex derivatives, if certain metrics are exceeded. The ECB's opinion[34] on the subject generally supported the Commission's proposal to ban proprietary trading, with the aim of preventing banks from directly engaging in high-risk proprietary trading in the future. From a financial stability perspective, there is also support for the separation of certain trading activities from the deposit-taking entity. However, the ECB considered it important to sufficiently preserve market-making activities, as they have an important role in increasing asset and market liquidity, moderating price volatility and increasing securities markets' resilience to shocks. This is essential for financial stability, the implementation and smooth transmission of monetary policy, and the financing of the economy. Such market-making activities could, therefore, be allowed to continue within the deposit-taking entity. The opinion also supports the separation of certain trading activities when metrics of activities exceed certain thresholds, although with a higher degree of supervisory discretion for assessing the separation. To this end, the metrics proposed by the Commission could usefully be complemented by additional qualitative and quantitative information that also captures the risks entailed by trading activities.

34 CON/2014/83.

Chapter 2
Other tasks and activities

1 Market infrastructure and payments

Market infrastructures are the backbone of financial markets as they enable the safe flow of funds and financial assets in the economy. Their smooth operation is crucial to maintaining confidence in the currency and supporting monetary policy operations and the stability of the financial system as a whole. The integration of market infrastructures across national borders in Europe is a necessary condition for achieving a truly single market, which will increase efficiency for consumers, companies and banks.

The Eurosystem plays a central role in this field. It provides payment and securities settlement services, oversees financial market infrastructures and payment instruments, and works with market stakeholders to achieve financial market integration. Cooperation and dialogue with other financial institutions and non-euro area central banks on policy aspects relating to regional and global developments in the field of market infrastructure and payments are also high on the Eurosystem's agenda.

1.1 Integration and innovation in retail payments

Retail payments are "everyday" payments between, for example, private persons, companies, non-governmental organisations and government agencies which are of relatively low value and typically not of a time-critical nature.

A major milestone was reached in this field on 1 August 2014 as the Single Euro Payments Area (SEPA) was successfully implemented for credit transfers and direct debits in the euro area, allowing consumers and businesses to use a single payment account for all euro credit transfers and direct debits. The migration period for euro-denominated credit transfers and direct debits in non-euro area countries will end on 31 October 2016. The Eurosystem has shaped the implementation of SEPA from its inception, playing a catalyst role in this major integration project and facilitating dialogue between all players.

Innovation in the field of retail payments, focusing on instant and mobile payments, and the integration of card payments are the next steps for SEPA. In April 2014 the ECB published a report entitled "Card payments in Europe – a renewed focus on SEPA for cards", which called for implementation of the vision of "any card at any terminal".

The Eurosystem also works with market stakeholders on the further development of an integrated, innovative and competitive market for euro retail payments via the Euro Retail Payments Board (ERPB). Through the ERPB, the Eurosystem is now actively involved in facilitating "instant payments" in euro, i.e. payments that flow in real time from the sender to the recipient, allowing the recipient to re-use the funds immediately. In December 2014 the ERPB launched work to facilitate person-to-person mobile payments and contactless proximity payments. The ERPB also published a set of recommendations to address remaining SEPA post-migration issues.

1.2 The large-value payment system for the euro: TARGET2

The Eurosystem operates the infrastructure for the real-time settlement of large-value and urgent euro payments in central bank money, TARGET2. TARGET2 settles, among other things, Eurosystem monetary policy operations and interbank transactions, thus fulfilling a crucial function for the euro area. Reaching 24 central banks of the EU and around 55,000 banks worldwide, TARGET2 is one of the largest payment systems in the world.

TARGET2 continued to function smoothly in 2014, reaching 100% availability. It settled a total of 90,337,036 transactions and had a turnover of €492,431 billion, corresponding to a daily average of 354,263 transactions and €1,931 billion. A reduction of 2.4% was observed in the settled volumes as compared with end-2013, driven by a decrease in the number of customer payments following the completion of the migration to SEPA instruments.

In 2014 work continued on migrating TARGET2 to new industry standards (ISO20022). Moreover, progress was made in ensuring that the system achieves full compliance with the ECB Regulation on oversight requirements for systemically important payment systems (see below for more details), particularly in the areas of risk assessment, liquidity stress testing and tiered participation.

1.3 Integrated and harmonised securities settlement: TARGET2-Securities

From June 2015 the Eurosystem's new infrastructure, TARGET2-Securities (T2S), will offer securities settlement in central bank money across borders in Europe. Between June 2015 and February 2017 as many as 24 European central securities depositories (CSDs) will outsource their securities accounts to T2S, and 23 NCBs will open cash accounts in T2S for the simultaneous and final transfer of securities against central bank money.

For T2S stakeholders 2014 was an intense year of testing and preparations. The T2S software, developed by the Deutsche Bundesbank, the Banco de España, the Banque de France and the Banca d'Italia, was made available for user testing with CSDs and NCBs on 1 October, after completion of the Eurosystem acceptance testing in September.

The prospect of T2S has created the conditions for the securities industry to work together to harmonise the way securities settlement is carried out across borders and to achieve greater safety and efficiency as well as an open competitive environment.[35]

1.4 Provision of Eurosystem collateral management services

Market players view the possibility of easily mobilising assets as collateral as crucial to their risk and liquidity management and to their compliance with regulatory requirements.

In order to facilitate the cross-border use of collateral for Eurosystem credit operations, the Eurosystem offers the Correspondent Central Banking Model (CCBM). In 2014 two improvements were made to the CCBM. The requirement to repatriate securities back to the issuer CSD before mobilising them via the CCBM was removed on 26 May; in addition, triparty collateral management services became accessible at the cross-border level via the CCBM as of 29 September. These enhancements enable counterparties to consolidate their collateral holdings in one, or just a few, CSDs of their choice and to manage their collateral more efficiently.

In view of market and regulatory developments that have led to higher demand for collateral, the ECB worked closely with the industry via its Contact Group on Euro Securities Infrastructures (COGESI), publishing three reports on important issues related to collateral eligibility, availability and mobility.

1.5 Oversight of market infrastructures and payment instruments

Disruptions in the financial market infrastructure can lead to major disruptions for the economy. The Eurosystem's oversight function plays a key role in making sure that risks are controlled and prevented to the largest possible extent, also taking into account international oversight standards and regulatory developments.[36]

To ensure the efficient management of risks and sound governance arrangements, the ECB adopted a Regulation on oversight requirements for systemically important payment systems, which entered into force on 12 August 2014. The Regulation is consistent with the Principles for financial market infrastructures issued by the Committee for Payments and Market Infrastructures of the BIS and the International Organization of Securities Commissions. On 20 August 2014 the ECB identified four systems as systemically important and therefore subject to the new Regulation: TARGET2 (operated by the Eurosystem itself), EURO1 and STEP2-T (operated by EBA CLEARING), and CORE(FR) (operated by STET). This list will be reviewed annually. The Eurosystem has conducted a gap analysis to ensure the compliance of TARGET2 with the new oversight requirements.

[35] More information on the post-trade harmonisation activities triggered by T2S can be found at www.harmonisation.T2S.eu

[36] More information on the Eurosystem's oversight activities can be found in the Eurosystem oversight report 2014.

The Eurosystem also undertook a comprehensive review of the oversight standards for euro retail payment systems that are not systemically important. As a result, the ECB published on 21 August 2014 the Revised Oversight Framework for Retail Payment Systems, according to which non-systemically important retail payment systems are subject to selected Principles for financial market infrastructures, according to the level of risk posed to the market served.

With regard to the oversight of securities and derivatives infrastructures, the main activities in 2014 were related to new regulation. The Eurosystem continued to work in the respective central counterparty colleges on the (re)authorisation of EU central counterparties with a large euro-denominated central clearing business under the European Market Infrastructure Regulation (EMIR), and it contributed to the drafting of the technical standards for the CSD Regulation. In addition, the oversight assessment of the T2S design continued in 2014 and will be finalised before T2S goes live in June 2015.

Payment instruments were also subject to oversight initiatives in 2014 aimed at increasing safety. In 2014 the Eurosystem finalised the assessment of 23 international and major domestic card payment schemes operating in the euro area against the harmonised Eurosystem oversight framework for card payment schemes. Most card schemes were found to observe or broadly observe the oversight standards, and the Eurosystem has started a dialogue with the operators of these schemes to address any outstanding issues. In November 2014 the ECB also published two guides for the assessment of direct debit schemes and credit transfer schemes against the oversight standards for payment instruments.

Finally, Eurosystem overseers continued to contribute to the work of the European Forum for the Security of Retail Payments (SecuRe Pay), a forum for voluntary cooperation for the European Banking Authority and the ESCB in their functions as regulators, supervisors or overseers.

2 Financial services to other institutions

2.1 Administration of borrowing and lending operations

In 2014 the ECB continued to be responsible for the administration of the borrowing and lending operations of the EU under the medium-term financial assistance facility (MTFA)[37], the European Financial Stabilisation Mechanism (EFSM)[38], the European Financial Stability Facility (EFSF)[39] and the European Stability Mechanism (ESM)[40]. Under the MTFA the ECB processed interest payments on 11 loans in 2014. As at 31 December 2014 the total outstanding amount under this facility was €8.4 billion. Under the EFSM the ECB processed payments, or interest payments, on 21 loans in 2014 and the total outstanding amount as at 31 December 2014 was €46.8 billion. On behalf of the EFSF the ECB processed four disbursement payments to the borrower countries (Portugal and Greece) and various interest and fee payments on the loans. On behalf of the ESM the ECB processed 26 payments in the form of ESM member contributions or in relation to the borrower countries (Cyprus and Spain).

Finally, the ECB continued to be responsible for processing all payments related to the loan facility agreement for Greece.[41] The balance outstanding as at 31 December 2014 was €52.9 billion.

2.2 Eurosystem Reserve Management Services

In 2014 a comprehensive set of financial services continued to be offered within the Eurosystem Reserve Management Services (ERMS) framework established in 2005 for the management of customers' euro-denominated reserve assets. Individual Eurosystem NCBs ("the Eurosystem service providers") offer the complete set of services under harmonised terms and conditions in line with general market standards to central banks, to monetary authorities and government agencies located outside the euro area, and to international organisations. The ECB performs an overall coordinating role, ensuring the smooth functioning of the framework and the reporting to the Governing Council.

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37 In accordance with Article 141(2) of the Treaty on the Functioning of the European Union, Articles 17, 21.2, 43.1 and 46.1 of the Statute of the ESCB, and Article 9 of Council Regulation (EC) No 332/2002 of 18 February 2002.

38 In accordance with Articles 122(2) and 132(1) of the Treaty on the Functioning of the European Union, Articles 17 and 21 of the Statute of the ESCB, and Article 8 of Council Regulation (EU) No 407/2010 of 11 May 2010.

39 In accordance with Articles 17 and 21 of the Statute of the ESCB (in conjunction with Article 3(5) of the EFSF Framework Agreement).

40 In accordance with Articles 17 and 21 of the Statute of the ESCB (in conjunction with Article 5.12.1 of the ESM General Terms for Financial Assistance Facility Agreements).

41 In the context of the loan facility agreement between the Member States whose currency is the euro (other than Greece and Germany) and Kreditanstalt für Wiederaufbau (acting in the public interest, subject to the instructions of and with the benefit of the guarantee of the Federal Republic of Germany) as lenders and the Hellenic Republic as borrower and the Bank of Greece as agent to the borrower, and pursuant to Articles 17 and 21.2 of the Statute of the ESCB and Article 2 of Decision ECB/2010/4 of 10 May 2010 concerning the management of pools of bilateral loans for the benefit of the Hellenic Republic and amending Decision ECB/2007/7.

The number of customers maintaining an ERMS business relationship with the Eurosystem was 296 in 2014, compared with 300 in 2013. With regard to the services themselves, in the course of 2014 the total aggregated holdings (which include cash assets and securities holdings) managed within the ERMS decreased by approximately 8% compared with the volume at the end of 2013.

When the deposit facility rate became negative, the demand for cash services offered within the ERMS framework decreased sharply. At the end of July 2014 the aggregated nominal figure for cash assets showed a decrease of €18 billion, when compared with end-June 2014 data, reflecting an accelerated cash outflow from the ERMS. At the same time, the holdings of euro-denominated securities kept with the ERMS registered a slight decrease of €3 billion.

During the second half of 2014 the holdings of cash assets continued to decrease, while the amount of securities held within the ERMS steadily increased. These trends suggest that, after assessing the impact of the negative deposit facility rate, customers adjusted their portfolios accordingly.

3 Banknotes and coins

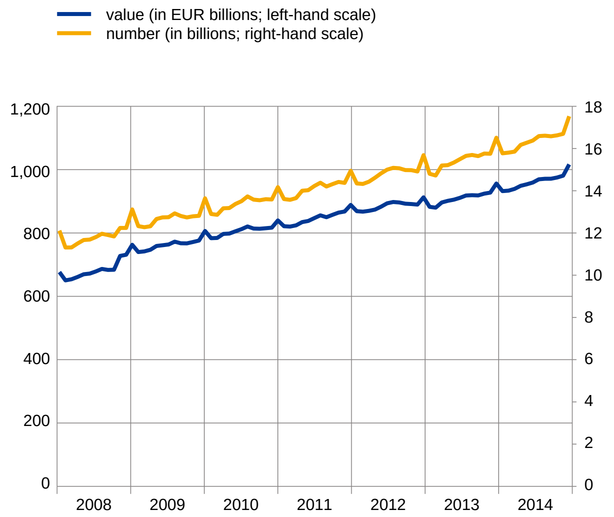
The ECB and the euro area NCBs are responsible for issuing euro banknotes within the EU and for maintaining confidence in the currency.

3.1 The circulation of banknotes and coins

In 2014 both the number and value of euro banknotes in circulation grew by around 6%. At the end of the year there were 17.5 billion euro banknotes in circulation, with a total value of €1,016.5 billion (see Charts 30 and 31). The production of euro banknotes is shared by the NCBs, which were responsible for the production of 8.3 billion banknotes in 2014.

Chart 30

Number and value of euro banknotes in circulation

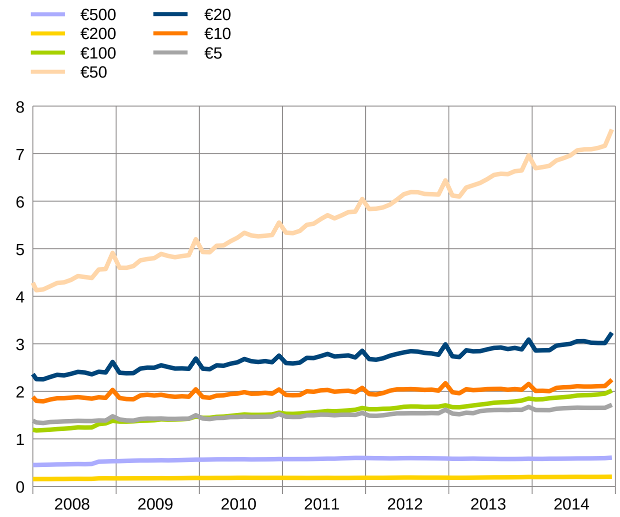


Source: ECB.

Chart 31

Number of euro banknotes in circulation by denomination

(billions)



Source: ECB.

It is estimated that, in terms of value, around a quarter of the euro banknotes in circulation are held outside the euro area, predominantly in countries neighbouring the euro area. In 2014 net shipments of euro banknotes by financial institutions to regions outside the euro area increased by 146%, or €19 billion. Euro banknotes, mainly high-value denominations, are held outside the euro area as a store of value and for settling transactions on international markets.

In 2014 the total number of euro coins in circulation increased by 4.6%, standing at 110.9 billion. At the end of 2014 the value of coins in circulation stood at €25.0 billion, 3.2% higher than at the end of 2013.

In 2014 the euro area NCBs checked the authenticity and fitness for circulation of some 33.6 billion banknotes, withdrawing around 5.9 billion of them from circulation. The Eurosystem also continued its efforts to help banknote equipment manufacturers to ensure that their machines meet the ECB's standards for machinery used by cash handlers to check euro banknotes for authenticity and fitness prior to recirculation. Around 40% of the total number of euro banknotes that were put back into circulation in 2014 were processed by cash handlers using such machines.

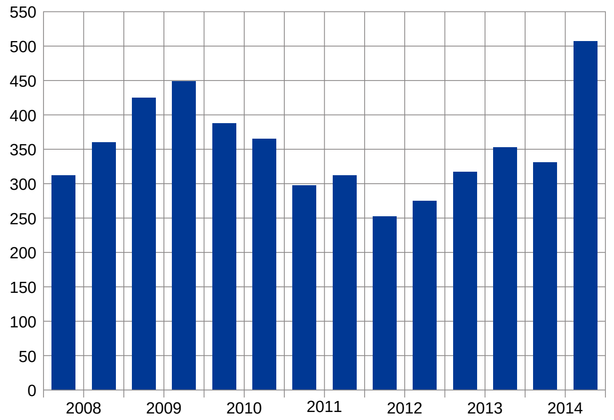
3.2 Counterfeit euro banknotes

In 2014 the Eurosystem withdrew some 838,000 counterfeit euro banknotes from circulation. When compared with the number of genuine euro banknotes in circulation, the proportion of counterfeits remains at a very low level. Long-term developments in the quantity of counterfeits removed from circulation are shown in Chart 32. Counterfeiters tend to target the €20 and €50 banknotes, which in 2014 accounted for 54.5% and 29.5% of total counterfeits respectively. The increase in the total number of counterfeits in the second half of 2014 was mainly driven by a rise in counterfeit €20 banknotes. Further details of the denominational breakdown are shown in Chart 33.

Chart 32

Number of counterfeit euro banknotes recovered from circulation

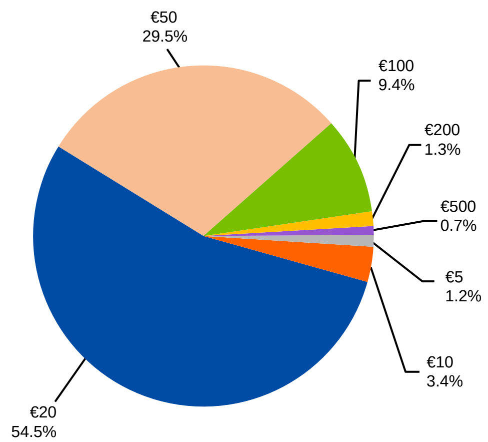
(thousands)



Source: ECB.

Chart 33

Breakdown of counterfeit euro banknotes by denomination in 2014



Source: ECB.

The ECB continues to advise the public to remain alert to the possibility of fraud, to remember the "feel-look-tilt" test, and never to rely on just one security feature. In addition, training is offered to professional cash handlers on a continuous basis, both in Europe and beyond, and up-to-date information material is made available to support the Eurosystem's fight against counterfeiting. The ECB also cooperates with Europol, Interpol and the European Commission in pursuit of this goal.

3.3 The second series of euro banknotes

On 23 September 2014 a new €10 banknote began circulating, the second banknote of the Europa series to be launched. Like the new €5 banknote, which entered circulation in May 2013, the new €10 banknote contains enhanced security features, including a portrait of Europa, a figure from Greek mythology, in the watermark and hologram. In the run-up to the introduction of the new €10 banknote, the ECB and the euro area NCBs conducted a campaign to inform both the public and professional cash handlers about the new banknote and its features. They also took several measures to help the banknote handling machine industry prepare for the introduction of the new banknote.

In December 2014 the Governing Council decided that the new €20 banknote will be introduced on 25 November 2015. The other denominations of the Europa series will be introduced gradually over several years in ascending order.

4 Statistics

The ECB, assisted by the NCBs, develops, collects, compiles and disseminates a wide range of statistics which are important to support the monetary policy of the euro area, the supervisory functions of the ECB, various other tasks of the ESCB and the tasks of the European Systemic Risk Board (ESRB). These statistics are also used by public authorities, financial market participants, the media and the general public.

In 2014 the ESCB continued to provide regular euro area statistics in a smooth and timely manner. In addition, it devoted considerable efforts to implementing the new international standards in all ECB statistics, improving the accessibility of ESCB data and the availability and quality of granular data, and establishing a new collection framework supporting the ECB's additional responsibility for banking supervision (see Section 3 of Chapter 1).

4.1 New and enhanced euro area statistics

From October 2014 the ESCB started to produce statistics according to the new international and European statistical standards for national accounts and balance of payments statistics, a process which was coordinated with Eurostat and the European Statistical System (ESS) and which covers a wide range of ESCB and ESS statistics. The implementation of the European System of Accounts 2010 (ESA 2010) and the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6) have led to an improved recording of financial and non-financial transactions and balance sheets in an increasingly globalised and interconnected economy.

4.2 Other statistical developments

The ESCB continued its work on enhancing the availability and quality of statistics on the basis of new or substantially improved micro-databases, as these provide more flexibility in meeting user needs and help to minimise the burden for reporting agents.

In February 2014 the ECB adopted a legal act[42] defining the preparatory work towards the step-by-step implementation of a long-term framework for the collection of granular credit data, i.e. data about the credit exposures of credit institutions or other loan-providing financial institutions vis-à-vis borrowers, based on harmonised ECB statistical reporting requirements. Work is ongoing on the final requirements and the final timetable for implementation.

In November 2014 the ECB adopted a Regulation on the collection of money market statistics. It defines the reporting by credit institutions of their daily individual transactions relating to various segments of the money market with other MFIs, other non-bank financial institutions and the general government, as well as wholesale

[42] Decision ECB/2014/6 of 24 February 2014 on the organisation of preparatory measures for the collection of granular credit data by the European System of Central Banks and the related Recommendation ECB/2014/7.

transactions with non-financial corporations.

Other important micro-datasets continued to support the production of statistics in 2014. The security-by-security information contained in the Centralised Securities Database supported the production of new monthly statistical indicators on debt securities issuance and debt service by EU governments which were released in November 2014. Similarly, the new database on holdings of individual securities by institutional sectors as well as by the largest individual banking groups has been supplied since end-2013 by data collected by the ESCB, and it is expected to play a crucial role in enhancing the coverage and quality of statistics on securities.

In November 2014 the ECB adopted a new Regulation[43] on insurance corporations' statistics, which allows the ECB essentially to re-use for monetary and financial stability purposes the data collected by supervisory authorities using the Solvency II quantitative reporting templates.

In 2014 the ECB continued to provide statistical support to the ESRB. Among other things, it chaired the Contact Group on Data which coordinates this statistical work by bringing together the European Supervisory Authorities as well as representatives of the member countries of the ESRB Steering Committee.

At the international level, the ECB takes an active role as co-chair of the Committee for the Coordination of Statistical Activities, which promotes inter-agency coordination and consistency in statistical practices, and as Vice-Chair of the Irving Fisher Committee on Central Banking Statistics, which contributes to the advancement of central bank statistics worldwide. Furthermore, the ESCB played a prominent role in the launch in November 2014 of the Special Data Dissemination Standard Plus, the third and highest tier of the IMF's Data Standards Initiatives. Seven of the nine countries in the first cluster of adherents to the Fund's initiative were EU Member States. This success reflects the continuous efforts of the ESCB Statistics Committee to enhance and broaden the base of European economic and financial statistics.

4.3 Accessibility of statistics – major steps in 2014

In October 2014 the ECB launched a new website called "Our statistics" tailored to facilitate access to and the re-use of core euro area breakdowns and national statistics using visualisations. One of the functions it offers is the possibility to share the visualisations and integrate them into other websites and social media.

Furthermore, in December 2014 a new tablet application called "ECBstatsApp" was released, providing tablet users[44] with easy access to statistics published in the ECB's Statistical Data Warehouse in different formats, such as tables, charts and maps. The ECB also launched a new web service allowing professional and private users to automatically download large volumes of statistics into their own data systems on a frequent basis.

43 Regulation ECB/2014/50 on statistical reporting requirements for insurance corporations.

44 The app is available for Android tablets and for iPads.

5 Economic research

One of the distinguishing features of central banks is that they have a long tradition of underpinning their policies with strong scientific foundations. In times of uncertainty and change, such as those currently being experienced, it is important that research pushes back frontiers by providing underpinnings for policies that have not been used before. The ECB continued to make considerable progress on this front in 2014.

5.1 The ECB's research clusters

Economic research at the ECB is conducted within 11 bank-wide research groups covering different topics of policy relevance. In 2014 research focused on five major areas: (i) financial instability and macro-prudential policies; (ii) monetary transmission, with an emphasis on non-standard monetary policy measures; (iii) the changing economic and financial structure since the crisis and its implications for growth; (iv) the interaction of monetary, fiscal and supervisory policies amid a changing EU institutional framework (notably the establishment of the SSM); and (v) forecasting, scenario analysis and country surveillance tools.

Important findings emerged in particular from research on the effectiveness of non-standard measures in the euro area. For instance, evidence collected around the announcements on the Outright Monetary Transactions suggests that those announcements may have had a positive impact on GDP and credit in stressed countries. Changes in collateral eligibility rules – as introduced by the additional credit claims programme of February 2012 – in combination with the very long-term refinancing operations also appear to have supported the economy by reducing the yields on, and increasing the purchases of, the targeted assets (corporate loans). Furthermore, an analysis of the possible effects of an asset purchase programme indicates that such a programme can be useful for managing risks to price stability also in circumstances in which there is no severe financial instability. Purchases of assets with higher yield premiums appear to be more effective in supporting the economy but also potentially riskier for the central bank.

A wide range of models and tools were developed in 2014 within the various research areas mentioned above. One such tool assesses the risk of a de-anchoring of inflation expectations stemming from a spillover of short-term to long-term expectations. Results for the euro area suggest that this risk increased significantly around January 2014 and remained high until the end of the year.

5.2 The Eurosystem/ESCB research networks

Eurosystem/ESCB research networks continued to make a significant contribution in 2014.[45] An important milestone was reached in June with the conclusion of the work of the Macro-prudential Research Network, which had been established in

[45] See the ECB's website for detailed information on each network.

2010 to develop better analytical underpinnings for the new area of macro-prudential policy.[46] One of the network's key contributions has been the development of a series of macroeconomic models featuring financial instability, something that was virtually absent from the economic literature before the crisis. These developments provide the necessary tools for a meaningful analysis of macro-prudential policies, such as in the case of a new model that incorporates bank defaults and allows the assessment of both the benefits and the costs of capital adequacy regulation. The network also developed a coincident indicator of systemic financial instability, the now widely used composite indicator of systemic stress, and several early warning models for systemic banking crises, confirming the important role of credit growth and leverage. Finally, the network derived – in cooperation with payment systems experts – information on the unsecured money market from the TARGET2 system. The data can be used to calculate indicators and assess developments relating to the euro money market, notably cross-border bank contagion risks and aspects of the systemic importance of banks. One finding was that the impact of bank risk and excess liquidity provided by the Eurosystem on interbank market activity depends crucially on the fiscal health of the country in which borrowing banks reside.

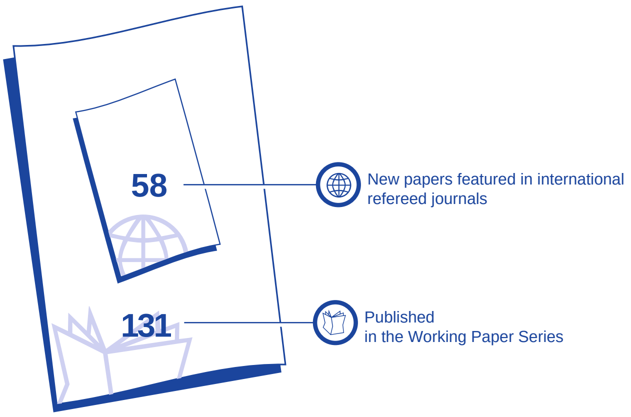
A second network – the Competitiveness Network – produced a new database based on non-financial corporations' balance sheets. A major finding in this context is that, despite the drop in employment, the recent crisis may have had "cleansing effects" on EU economies, as it appears to have accelerated resource reallocation towards the most productive firms, particularly in economies under stress. The crisis may also have caused the share of credit-constrained firms to increase at different rates across countries and along the percentiles of the productivity distribution, with the most productive firms not suffering from credit rationing.

A third network – the Household Finance and Consumption Network – focused on the analysis of data made available by the Eurosystem's Household Finance and Consumption Survey. Research was conducted on euro area households' financial fragility, the distributional effects of inflation and monetary policy, cross-country differences in household wealth distribution, and the recent evolution of wealth, income and debt service. A major finding is that, while the mortgage debt service/ income ratios of individual households generally declined after the crisis, the fall was counteracted by the rise in unemployment and resulting drop in income.

Finally, a previous ESCB network – the Wage Dynamics Network – was re-established to conduct a third wave of the survey on firms' price and wage policies. This wave aimed to assess how firms have adjusted in response to the crisis and to enable an evaluation of the relevance of recent labour market reforms in shaping these adjustments. The survey data have been collected and country-specific studies are ongoing.

[46] A complete summary of the network's research output and conclusions can be found in its final report. The ECB is involved in macro-prudential policy through its role in the European Systemic Risk Board and through the macro-prudential competencies of the Single Supervisory Mechanism (see Section 3 of Chapter 1).

ECB Working Papers in 2014



5.3 Conferences and publications

The ECB continued to be active in the organisation of research events. In addition to a large number of invited speaker seminars, the ECB hosted and/or co-organised several high-level conferences. Important events included the ECB Forum on Central Banking in Sintra, the concluding conference of the Macro-prudential Research Network and the International Research Forum on Monetary Policy.

A large proportion of the ECB's research output was published. In total, 131 new papers appeared in the ECB's Working Paper Series in 2014, and 58 ECB contributions featured in international refereed journals.

6 Legal activities and duties

In 2014 the ECB adopted a number of legal acts and instruments in the area of monetary policy and central banking, as well as in relation to its newly assumed supervisory responsibilities. The ECB also adopted numerous opinions in response to the Treaty-based requirement for the ECB to be consulted on any proposed EU act or draft national legislation falling within its fields of competence. In addition, the ECB took part in several judicial proceedings before the European courts.

6.1 Legal developments related to the SSM

As part of its new supervisory responsibilities, the ECB in 2014 adopted several legal acts in relation to the establishment of the SSM, most of which are discussed in the ECB Annual Report on supervisory activities 2014. From an institutional perspective, the following legal acts related to the establishment of the SSM are of relevance.

In line with Article 25 of the SSM Regulation, the Governing Council adopted, in addition to the measures already taken regarding the separation between monetary policy and supervisory tasks under Article 25, a Decision on separation[47]. This Decision contains, in particular, provisions relating to professional secrecy and the exchange of information between the two policy areas. The Decision entered into force on 18 October 2014.

The ECB Decision on close cooperation[48] was adopted by the Governing Council and entered into force on 27 February 2014. On the basis of Article 7 of the SSM Regulation, according to which non-euro area EU Member States may participate in the SSM under a regime of close cooperation, the Decision sets out the procedural aspects of close cooperation between the ECB and the competent authorities of a participating Member State.

The Governing Council amended the ECB's Rules of Procedure on 22 January 2014[49] in order to set out in detail the relationship between the Governing Council and the Supervisory Board as required by the SSM Regulation. In particular, the revised rules establish the interaction between the Governing Council and the Supervisory Board within the non-objection procedure. Under this procedure, draft decisions by the Supervisory Board will be deemed adopted unless the Governing Council objects within a defined period of time, not exceeding ten working days. Moreover, certain rules governing the Supervisory Board's procedures have been incorporated into the ECB's Rules of Procedure. On 31 March 2014 the Supervisory Board adopted its own Rules of Procedure[50], after having consulted the

47 Decision ECB/2014/39 of 17 September 2014 on the implementation of separation between the monetary policy and supervision functions of the European Central Bank, OJ L 300, 18.10.2014, p. 57.

48 Decision ECB/2014/5 of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro, OJ L 198, 5.7.2014, p. 7.

49 Decision ECB/2014/1 of 22 January 2014 amending Decision ECB/2004/2 adopting the Rules of Procedure of the European Central Bank, OJ L 95, 29.3.2014, p. 56.

50 Decision of 31 March 2014 establishing the Rules of Procedure of the Supervisory Board of the ECB, OJ L 182, 21.6.2014, p. 56.

Governing Council. They supplement the ECB's Rules of Procedure and also include rules concerning the composition of the Steering Committee.

Under the SSM Regulation, the Governing Council is to establish and publish a Code of Conduct for the ECB staff and management involved in banking supervision. The ECB has adopted rules of ethical conduct as part of a general review of the Ethics Framework that applies to all ECB staff. These rules entered into force on 1 January 2015 and take account of the requirement under the SSM Regulation that comprehensive and formal procedures and proportionate periods are to be established and maintained in order to assess in advance, and prevent, possible conflicts of interest of ECB staff members engaged in supervisory activities resulting from subsequent employment. As codes of conduct are in place for both the Executive Board and the Governing Council, it was decided that a separate code was also required for the Supervisory Board. This Code of Conduct was approved by the Supervisory Board on 12 November 2014 and entered into force on 13 November 2014. Its purpose is to provide a general framework of high ethical standards which the members of the Supervisory Board and other participants in Supervisory Board meetings must observe and to establish concrete procedures to deal with, for example, potential conflicts of interest.

6.2 ECB participation in judicial proceedings at the EU level

The ECB also took part in various judicial proceedings at the EU level. On 6 February 2014 the Court of Justice of the European Union dismissed the appeal of Gabi Thesing and Bloomberg Finance LP against the ECB in case C-28/13 P. The decision of the General Court of the EU in its judgement of 29 November 2012 that the ECB was entitled to refuse access to two internal documents related to the public deficit and the public debt of Greece was confirmed. The European courts agreed with the ECB's defence that their disclosure would have specifically and effectively undermined the protection of the public interest as regards the economic policy of the EU and of Greece, and that the risk of that undermining was reasonably foreseeable and not purely hypothetical. The Court recognised that the ECB enjoys wide discretion in assessing whether the disclosure of ECB documents undermines the public interest as regards the economic, financial or monetary policy of the EU or of a Member State.

By way of, among other things, a constitutional complaint, the Outright Monetary Transactions detailed in an ECB press release on 6 September 2012 were brought before the German Federal Constitutional Court. Following a hearing in June 2013, the Constitutional Court decided on 14 January 2014 to request a preliminary ruling by the Court of Justice of the European Union based on a set of questions on the interpretation of several provisions of EU law. As a follow-up, the Court of Justice conducted a hearing on 14 October 2014. The Advocate General of the Court of Justice delivered his opinion on 14 January 2015, and the preliminary ruling by the Court of Justice can be expected in the first half of 2015. On the basis of the preliminary ruling, the German Federal Constitutional Court will deliver its final judgement on the compatibility of the Outright Monetary Transactions with the German constitution.

In the course of 2014 several depositors and shareholders of Cypriot credit institutions filed lawsuits against the ECB and other EU institutions, asking for damages and/or requesting the annulment of acts that they deemed to have led to the restructuring of these credit institutions in the context of the financial assistance programme for Cyprus. The General Court dismissed 12 of these cases in their entirety as inadmissible. The involvement of the ECB in the process leading up to the conclusion of the financial assistance programme was limited to the provision of technical advice, pursuant to the Treaty establishing the European Stability Mechanism, acting in liaison with the European Commission, and the issuance of a non-binding opinion on the Cypriot draft resolution law.[51]

In 2014 holders of Greek government bonds continued to engage in litigation against the ECB. Applicants alleged that they had suffered financial loss and been deprived of their fundamental rights to property and economic freedom following the enactment of legislation by the Greek Parliament in February 2012 which led to a partial restructuring of Greece's sovereign debt. The overall role of the ECB in the context of this restructuring was merely advisory and within the boundaries of its mandate under the Treaty on the Functioning of the European Union. The General Court has already ruled in favour of the ECB in the context of one dispute with Greek government bond holders, with the latter failing to establish direct and individual concern – an essential condition for admissibility of every action. No appeal has been filed with the Court of Justice.

6.3 ECB opinions and cases of non-compliance

Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union require that the ECB be consulted on any proposed EU or draft national legislation falling within its fields of competence.[52] All ECB opinions are published on the ECB's website. ECB opinions on proposed EU legislation are also published in the Official Journal of the European Union.

In 2014 the ECB adopted 11 opinions on proposed EU legislation and 81 opinions on draft national legislation falling within the ECB's fields of competence.

A significant number of consultations by national authorities concerned measures relating to financial market stability.[53] The ECB adopted opinions in relation to, among other things, consumer loan contracts denominated in forint or in foreign currency entered into by private persons in Hungary,[54] a draft law establishing a systemic risk committee in Luxembourg,[55] a draft law establishing a special legal framework for the treatment of deferred tax assets of companies and state-owned enterprises, including

51 See Case T-289/13 Ledra Advertising Ltd v Commission and ECB, 2014, paragraph 45.

52 The United Kingdom is exempt from the consultation obligation, pursuant to the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, which is annexed to the Treaty, OJ C 83, 30.3.2010, p. 284.

53 See e.g. CON/2014/16, CON/2014/29, CON/2014/39, CON/2014/46, CON/2014/59, CON/2014/60, CON/2014/61, CON/2014/66 and CON/2014/67.

54 CON/2014/59, CON/2014/72, CON/2014/76, CON/2014/85 and CON/2014/87.

55 CON/2014/46.

credit institutions, that are liable for corporation tax,[56] measures accompanying the SSM Regulation in Austria,[57] a framework for the resolution of credit and other institutions,[58] the implementation of the Bank Recovery and Resolution Directive,[59] and public access to specific information concerning the bad loans of certain banks[60].

In the context of central bank independence, the ECB commented on, among other things, legislative provisions on the remuneration of members of an NCB's decision-making bodies and its employees,[61] on changes in the governance of the Banca d'Italia,[62] on the use of funds resulting from a possible reduction in the remuneration of staff and members of decision-making bodies at the Banca d'Italia,[63] and on the conflict of interest rules for senior officials of the Banco de España[64].

Other ECB opinions related to a draft law concerning the rounding of payments denominated in euro in Belgium,[65] and to the amendments of the Rules of Procedure of the Slovak Parliament, which aim to ensure the proper and timely consultation of the ECB on draft legislative provisions proposed by Members of Parliament and parliamentary committees[66].

25 cases of non-compliance with the obligation to consult were recorded, with the following cases being considered clear and important[67].

The Belgian authorities did not consult the ECB on an amendment to the Law of 21 December 1994 on various social provisions with a view to introducing complementary indicators intended to measure the quality of life, human development, social progress and the sustainability of the domestic economy. An obligation was imposed on the Nationale Bank van België/Banque Nationale de Belgique to publish in its Annual Report a summary of the results of the complementary indicators compiled by the National Account Institute.

Although the ECB was consulted by the Cypriot Ministry of Finance on certain draft amendments to the Resolution of Credit and Other Institutions Law, the amendments were voted into law before the ECB issued its opinion[68] on the subject.

56 CON/2014/66.

57 CON/2014/43.

58 CON/2014/60.

59 CON/2014/67.

60 CON/2014/39.

61 CON/2014/7, CON/2014/12 and CON/2014/38.

62 CON/2014/19.

63 CON/2014/38.

64 CON/2014/22.

65 CON/2014/6.

66 CON/2014/54.

67 These include (i) cases where a national authority failed to submit draft legislative provisions within the ECB's field of competence for consultation to the ECB; and (ii) cases where a national authority formally consulted the ECB, but did not afford it sufficient time to examine the draft legislative provisions and to adopt its opinion prior to adoption of these provisions.

68 CON/2014/60.

The ECB was consulted on draft amendments to the Law on the establishment of the Hellenic Financial Stability Fund. However, the Greek Parliament adopted the draft amendments only a few days later, before the ECB could issue the relevant opinion[69]. The following Greek legislation was not submitted to the ECB for consultation at all: Law No 4281/2014, related to the role of the Bank of Greece in ensuring compliance with the Code of Conduct for the management of non-performing private debt, the Law on out-of-court restructuring of corporate debt vis-à-vis financial institutions provisions[70], an amendment[71] to Law No 3213/2003 which, among other things, imposed an asset declaration obligation on the Governor, Vice-Governors, executive directors and directors of the Bank of Greece, and Law No 4308/2014 on Greek accounting standards and related provisions which affect the Bank of Greece. Draft legislative provisions on deferred tax assets of legal entities, including credit institutions, as well as amendments thereto, were submitted to the ECB for consultation but enacted prior to the adoption by the ECB of its opinion on the matter.

The ECB was not consulted by the Luxembourg authorities on the Law of 28 July 2014 on the immobilisation of shares and corporate units issued in bearer form.

The Hungarian draft law on certain measures relating to consumer loan contracts, as well as the draft law on the rules applicable to specific consumer loan contracts, were submitted to the ECB for consultation, but enacted shortly thereafter, before the ECB could adopt its opinions[72]. Likewise, the Hungarian authorities did not afford the ECB sufficient time to adopt its opinions on a draft law establishing a resolution framework for credit institutions and investment firms, a draft law on the general terms and conditions of consumer loan contracts and a draft law on the conversion of foreign exchange loans.[73]

In addition, the failures to consult the ECB by Cyprus, Greece, Hungary, Ireland, Italy and Slovenia were considered to be clear and repetitive cases.

6.4 Compliance with the prohibition of monetary financing and privileged access

Pursuant to Article 271(d) of the Treaty on the Functioning of the European Union, the ECB is entrusted with the task of monitoring the compliance of the EU NCBs and the ECB with the prohibitions implied by Articles 123 and 124 of the Treaty and Council Regulations (EC) Nos 3603/93 and 3604/93. Article 123 prohibits the ECB and the NCBs from providing overdraft facilities or any other type of credit facility to governments and EU institutions or bodies, as well as from purchasing in the

69 CON/2014/29.

70 The relevant provisions are incorporated into Law 4307/2014 transposing three Council framework decisions on the application of the principle of mutual recognition in criminal matters, Government Gazette Vol. A 246/15.11.2014.

71 Law on measures for the support and growth of the Greek economy, organisational matters of the Ministry of Finance and other provisions (Government Gazette Vol. A 160/8.8.2014).

72 CON/2014/59 and CON/2014/72.

73 CON/2014/62, CON/2014/85 and CON/2014/87.

primary market debt instruments issued by these institutions. Article 124 prohibits any measure, not based on prudential considerations, which establishes privileged access by governments and EU institutions or bodies to financial institutions. In parallel with the Governing Council, the European Commission monitors Member States' compliance with the above provisions.

The ECB also monitors the EU central banks' secondary market purchases of debt instruments issued by the domestic public sector, the public sector of other Member States and EU institutions and bodies. According to the recitals of Council Regulation (EC) No 3603/93, the acquisition of public sector debt instruments in the secondary market must not be used to circumvent the objective of Article 123 of the Treaty. Such purchases should not become a form of indirect monetary financing of the public sector.

The monitoring exercise conducted for 2014 confirms that the provisions of Articles 123 and 124 of the Treaty and the related Council Regulations were in general respected.

The monitoring exercise revealed that not all EU national central banks have remuneration policies for public sector deposits in place that fully comply with the remuneration ceilings[74]. In particular, a few NCBs need to ensure that the ceiling for the remuneration of public sector deposits is the unsecured overnight interest rate even when the latter is negative.

The reduction of IBRC-related assets by the Central Bank of Ireland during 2014 is a step in the direction of the necessary full disposal of these assets. However, a more ambitious sales schedule, in particular for the long-duration floating rate notes, would further mitigate the persisting serious monetary financing concerns.

The Magyar Nemzeti Bank (MNB) launched several programmes not related to monetary policy, including a real estate investment programme, a programme to promote financial literacy and a programme of purchases of Hungarian artworks and cultural property, as well as transferring staff formerly employed by the Hungarian Financial Supervisory Authority to the MNB. Given the multitude of programmes, their scope and their size, these programmes could be perceived as potentially in conflict with the monetary financing prohibition, to the extent that they could be viewed as the MNB taking over state tasks or otherwise conferring financial benefits on the state. The ECB will closely monitor these operations with a view to ensuring that their implementation does not lead to a conflict with the prohibition of monetary financing.

[74] These ceilings are included in Decision ECB/2014/8 on the prohibition of monetary financing and the remuneration of government deposits by national central banks and Guideline ECB/2014/9 on domestic asset and liability management operations by the national central banks, as amended by Guideline ECB/2014/22.

7 Institutional environment

7.1 Euro area enlargement

Adoption of the euro in Lithuania – a major step in European integration

On 23 July 2014 the EU Council adopted a Decision allowing Lithuania to introduce the euro as its currency from 1 January 2015, increasing the number of euro area countries from 18 to 19. The Council's Decision was based on the convergence reports published by the ECB and the European Commission in June 2014, and followed discussions by the European Council, an opinion of the European Parliament, a proposal from the European Commission and a recommendation by the Eurogroup. On the same day, the EU Council also adopted a Regulation fixing the irrevocable conversion rate between the Lithuanian litas and the euro. This conversion rate was set at LTL 3.45280 to the euro, which was equal to the central rate of the Lithuanian litas throughout Lithuania's membership of the exchange rate mechanism II (ERM II).

The logistics of the cash changeover – a successful operation

On 1 January 2015 Lithuania adopted the euro as its currency. The cash changeover went smoothly and, following a two-week period during which Lithuanian litas and euro cash circulated in parallel, the euro banknotes and coins became the sole legal tender in Lithuania.

The Deutsche Bundesbank, which acted as the logistical counterpart, provided 132 million banknotes worth €4.76 billion. Lietuvos bankas, the central bank of Lithuania, will repay that loan in the form of banknotes in 2016. Lietuvos bankas procured 370 million euro coins worth €120.6 million from the Lithuanian Mint.

In terms of value, 12% of the borrowed euro banknotes and nearly 55% of the procured euro coins were distributed to banks before the changeover date so that they could fill ATMs and provide retailers and other professional cash handlers with euro cash. In addition, about 900,000 starter kits, each containing euro coins with a value of €11.59, were distributed to the general public, helping to reduce the amount of change to be kept by retailers in the first few days of January.

From 1 January 2015, for a period of six months, litas can be exchanged for euro at the fixed exchange rate free of charge at all bank branches providing cash services. Many post office branches and some credit unions provided the same service for 60 days after the changeover date.

Lietuvos bankas will continue to redeem Lithuanian litas banknotes and coins for an unlimited period of time.

The information campaign on the introduction of the euro

The ECB worked closely with Lietuvos bankas to prepare a comprehensive information campaign to familiarise the general public and cash handlers with the visual appearance and security features of the euro banknotes and to provide information on key facts and dates related to the changeover.

The communication tools included a mass media campaign involving two television commercials, print, outdoor and online advertising, different types of printed publication, dedicated internet pages and the ECB's Euro Exhibition, which was held at the Palace of the Grand Dukes of Lithuania in Vilnius from 23 October 2014 to 5 January 2015. Communication partners (mainly banks, supermarkets, public authorities and large retail chains) were given access to material produced by the ECB, which they could pass on to their customers and employees.

In addition to the measures targeted at the general public, a high-level conference aimed at representatives of government, civil society and the media was held on 25 September 2014 with the participation of the President of the ECB, the Chairman of the Board of Lietuvos bankas, the European Commission Vice-President for Economic and Monetary Affairs and the Euro, and the Prime Minister and Finance Minister of Lithuania.

7.2 The integration of Lietuvos bankas into the Eurosystem

Legal aspects

Pursuant to Article 140 of the Treaty on the Functioning of the European Union, the ECB reviewed the statute of Lietuvos bankas and other relevant Lithuanian legislation for compliance with Article 131 of the Treaty. The ECB made a favourable assessment of the compatibility of Lithuanian legislation with the Treaty and with the Statute of the ESCB.

The ECOFIN Council consulted the ECB on its proposals to amend the Council regulations which enabled the introduction of the euro in Lithuania and determined the irrevocably fixed exchange rate of the euro vis-à-vis the Lithuanian litas. The ECB welcomed the proposed regulations and noted that they would enable the introduction of the euro as the currency of Lithuania following the abrogation of Lithuania's derogation in accordance with the procedure set out in Article 140(2) of the Treaty.

The ECB and Lietuvos bankas put in place a number of legal instruments with a view to ensuring the integration of Lietuvos bankas into the Eurosystem on 1 January 2015. The ECB adopted the necessary legal instruments to provide for the paying-up of the remaining capital and the transfer of foreign reserves to the ECB and established the banknote allocation key applicable from 1 January 2015. Pursuant to Article 27.1 of the Statute of the ESCB, the Governing Council adopted a recommendation on Lietuvos bankas' external auditors for the annual accounts starting from the financial year 2015. The ECB also reviewed its legal framework and introduced, where necessary, amendments resulting from Lietuvos bankas' membership of the Eurosystem. This included a review of Lithuanian legislation implementing the Eurosystem's legal framework for monetary policy and TARGET2, which enabled Lithuanian counterparties to participate in the Eurosystem's open market operations from 2 January 2015. The ECB also adopted a Decision on transitional provisions for the application of minimum reserves by the ECB following the introduction of the euro in Lithuania. Finally, the ERM II Agreement was terminated for Lietuvos bankas.

The introduction of the euro in Lithuania and the integration of its central bank into the Eurosystem also required changes to some Lithuanian legal instruments. The ECB was consulted on national legislation governing the euro changeover and the minimum reserves framework.

Operational aspects

The ECB also conducted technical preparations with a view to fully integrating Lietuvos bankas into the Eurosystem. In line with the provisions of the Treaty, Lietuvos bankas joined the Eurosystem with exactly the same rights and obligations as the NCBs of the EU Member States that had already adopted the euro.

The technical preparations for the integration of Lietuvos bankas into the Eurosystem covered a wide range of areas, notably financial reporting and accounting, monetary policy operations, foreign reserve management and foreign exchange operations, payment systems, statistics and banknote production. In the field of operations, preparations involved extensive testing of the instruments, procedures and technical systems for the implementation of monetary policy and foreign exchange operations.

With effect from 1 January 2015, 90 Lithuanian credit institutions, a list of which is published on the ECB's website, became subject to the Eurosystem's reserve requirements. The entry of Lithuania into the euro area changed the liquidity conditions in the Eurosystem only slightly. The aggregate reserve requirements of euro area credit institutions increased by 0.15% (€154 million). Net autonomous liquidity factors in Lithuania for the period from 1 to 27 February 2015 were liquidity-absorbing, increasing the liquidity deficit of the entire euro area banking sector by 0.8% (€4.1 billion) on average.

Contribution to the ECB's capital and foreign reserve assets

Lietuvos bankas' total subscribed share in the ECB's capital amounts to €44.7 million, equivalent to 0.4132% of the ECB's subscribed capital of €10.825 billion as at 1 January 2015. Upon joining the ESCB on 1 May 2004, Lietuvos bankas paid up 7% of its share of the subscribed capital of the ECB as a contribution to the ECB's operational costs; in conjunction with the ECB's capital increase on 29 December 2010 this contribution was reduced to 3.75%. In accordance with Article 48.1 of the Statute of the ESCB, Lietuvos bankas paid up the remaining part of its subscription, equal to €43.1 million, on 1 January 2015.

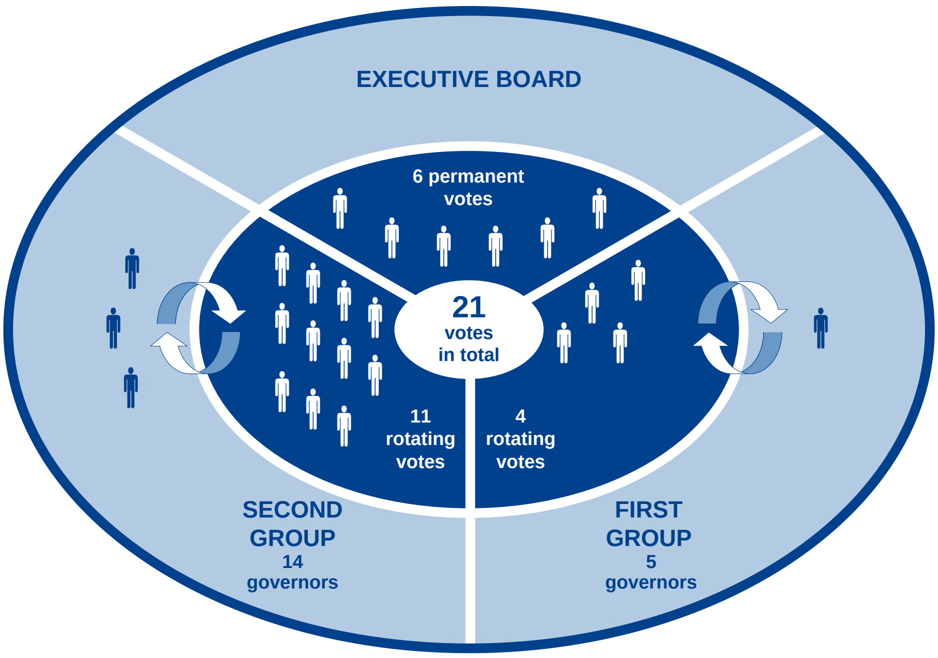
Lithuania transferred its contribution to the foreign reserve assets of the ECB at the beginning of January 2015 (85% of which was in US dollars and 15% in gold).

In order to reduce overall costs, improve efficiency and create a portfolio with an appropriate size in relation to the total amount of the ECB's foreign reserve assets invested in US dollars, Lietuvos bankas decided to pool its contribution with the foreign reserves of the Banco de Portugal, sharing all functions and responsibilities in the management of the joint portfolio, as other NCBs have done in the past.

Rotation of voting rights in the Governing Council

The entry of Lithuania into the euro area and the participation of the Chairman of the Board of Lietuvos bankas in the Governing Council triggered the implementation of rotating voting rights in the Governing Council as foreseen in Article 10.2 of the Statute of the ESCB. The Statute and Decision ECB/2008/29 of 18 December 2008[75] establish that as soon as there are 19 governors represented in the Governing Council, the number of members who have a voting right is limited to 21. As the members of the Executive Board are not subject to the rotation, this means that the governors share on a rotating basis the remaining 15 votes. For this purpose, governors have been placed in two groups on the basis of economic and financial factors. The first group consists of five governors and shares four voting rights, while the second group comprises all the other governors and shares the remaining 11 votes. The rotation period is set at one month, which means that the composition of voting members will change every month (according to a schedule).

Two-group rotation system for the Governing Council of the ECB with 19 countries in the euro area



[75] This Decision postponed the start of the rotation of voting rights in the Governing Council.

The system is based on five fundamental principles, namely: (i) the principle of “one member, one vote”; (ii) the principle of participation, which ensures that members maintain their right to participate in the meetings and speak even if they do not have a voting right; (iii) the principle of representativeness, which is achieved by the allocation of governors to groups; (iv) the principle of robustness, which means that the system will be able to accommodate any further enlargement; and (v) the principle of transparency.[76]

[76] For a more detailed description of the rotation system of voting rights in the Governing Council, see the Frequently Asked Questions on the ECB’s website.

8 International and European relations

8.1 European relations

As Europe continued to deal with the legacy of the economic and financial crisis, the ECB maintained its close dialogue with European institutions and fora, in particular with the European Parliament, the European Council, the ECOFIN Council, the Eurogroup and the European Commission.

2014 saw decisive steps to address financial sector fragmentation and the repair of the financial sector in the euro area with the agreement on the Single Resolution Mechanism (SRM) between the EU Council and the European Parliament and the establishment of the Single Supervisory Mechanism (SSM). At the same time, the economic situation in the euro area shaped the agendas of Eurogroup and ECOFIN Council meetings, in which the President of the ECB and other members of its Executive Board participated regularly. The need for a coherent strategy for monetary, fiscal, financial and structural policies in order to restore growth in Europe featured prominently in the European Council meetings and Euro Summits to which the President of the ECB was invited.

The Euro Summit of 24 October 2014 called on the President of the Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup and the President of the ECB, to prepare the next steps on better economic governance in the euro area in order "to develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity".

8.1.1 2014 – a new start for Europe

In 2014 European citizens were asked to elect a new European Parliament. It was the first time that Article 17 of the Treaty on European Union was put into practice and that the European Parliament elected, and did not simply approve, the President of the new European Commission. The new Commission, presided over by Jean-Claude Juncker, took office on 1 November 2014. On 6 November 2014 the Commission Vice-President for the Euro and Social Dialogue, Valdis Dombrovskis, participated in the meeting of the ECB's Governing Council. The Commission's internal structure was changed considerably. Among other things, the need for companies to have access to more diversified sources of financing was reflected in the creation of a new Directorate General for Financial Stability, Financial Services and Capital Markets Union, which has been given the task of helping to create an EU capital markets union. In addition, the European Council elected Donald Tusk as its second permanent President, who will again also serve as President of the Euro Summit.

The ECB is primarily held accountable for its actions by the democratically elected representatives of European citizens in the European Parliament. In 2014 the ECB's President attended four regular hearings of the Committee on Economic and Monetary Affairs of the European Parliament, which took place on 3 March, 14 July, 22 September and 17 November. The ECB's non-standard monetary policy measures, the worsening economic outlook including low inflation, and persistent financial fragmentation continued to be of great interest for MEPs at these hearings. At the hearing on 3 March, the President thanked the outgoing MEPs for their constructive role on a number of legislative dossiers. In addition to the President's regular hearings, the Vice-President of the ECB presented the ECB's Annual Report for 2013 to the committee on 7 April 2014, and the Parliament adopted its resolution on the matter on 25 February 2015.

The ECB also discharges its accountability obligations through regular reporting and by answering written questions from MEPs. In 2014 the ECB replied to 46 questions by MEPs and published the replies on its website. Most of the questions focused on the implementation of the ECB's monetary policy, the economic outlook and the situation in countries under an EU-IMF macroeconomic adjustment programme.

In 2014 the European Parliament concluded a high-level own-initiative report on the work of the European Commission, the IMF and the ECB in relation to these programmes. Executive Board member Benoît Cœuré participated in an exchange of views on 13 February 2014 to explain the ECB's role in this context. He also participated in the European Parliamentary Week on the European Semester for Economic Policy Coordination. In addition, the ECB provided input into the discussions of the European Parliament and the EU Council on legislative proposals falling within its fields of competence by explaining its legal opinions to relevant counterparts, for example in the cases of the SRM Regulation or the Payment Services Directive II.

8.1.2 Inter-institutional relations on the ECB's supervisory tasks

The SSM Regulation, which outlines the ECB's responsibilities with regard to banking supervision, also sets out a robust accountability framework for the ECB vis-à-vis the European Parliament and the EU Council concerning the related tasks. This framework is further detailed in an inter-institutional agreement between the European Parliament and the ECB, and in a Memorandum of Understanding between the EU Council and the ECB.

In the context of this framework, the Chair of the Supervisory Board of the ECB attended two regular public hearings in 2014 (18 March and 3 November) and two ad hoc exchanges of views (4 February and 3 November) with the Committee on Economic and Monetary Affairs. In addition, the ECB regularly transmitted to the committee the confidential records of proceedings of its Supervisory Board meetings. Ten replies to written questions posed by MEPs were published on the ECB's website.

With regard to the EU Council, the Chair of the Supervisory Board attended ECOFIN Council and Eurogroup meetings on four occasions in 2014, and from 4 November began discharging her duties of accountability towards the Council through the Eurogroup.

8.2 International relations

Against the background of a very dynamic and at times challenging international environment, the ECB participated in discussions of international institutions and fora which deal with global economic, financial and monetary issues. The ECB also further developed its bilateral relations with central banks in advanced and emerging economies.

Discussions at the global level on the subject of central banks' actions demonstrated a broad consensus that the accommodative monetary policies in advanced economies, including unconventional monetary policy measures, had been supportive of the global recovery. At the same time, there was recognition of the need to remain mindful of unintended consequences and potential spillover effects on other countries, in particular as some advanced economies move towards monetary normalisation.

8.2.1 G20

Amid the subdued global economic recovery, discussions in the G20 focused on the need to foster global growth and to tackle near-term risks to the economic outlook. In that context, at their summit in Brisbane, the G20 leaders remained resolute in their commitment to achieve strong, sustainable and balanced growth and to create new jobs. In line with the objective set in February in Sydney, G20 members presented growth strategies aimed at raising their aggregate GDP level by (at least) 2% within five years. Those commitments, along with other measures to lift investment (such as the Global Infrastructure Initiative also agreed in Brisbane), to increase trade and competition, to boost employment and to strengthen the stability of the financial system and fairness of the international tax system, should support sustainable and inclusive development. In their Brisbane Action Plan, G20 leaders stressed that G20 members will hold each other accountable for delivering on those commitments.

8.2.2 Policy issues related to the IMF and the international financial architecture

The ECB contributed to discussions at the IMF on the international financial architecture and supported the coordination of common European positions in this respect. Drawing lessons from the crisis and thereby helping to reduce the likelihood of severe future crises was the focal point of many discussions.

The IMF's 2014 Triennial Surveillance Review took stock of the contribution of IMF surveillance to the Fund's ultimate goal of promoting global economic and financial stability. It is vital that Fund surveillance and advice fully reflect the specific policy-making frameworks and respective competences of individual EU Member States, as well as at the euro area and the EU level, with a view to providing more consistent and effective surveillance, also in the light of the recent reforms to strengthen European economic governance and surveillance, notably in the euro area. EU central banks elaborated on this topic in a report by the Task Force on IMF Issues of the International Relations Committee of the ESCB. In 2014 the IMF made some modifications to its precautionary lending instruments with the backing of EU Member States. These instruments, including the flexible credit line and the precautionary and liquidity line, were introduced from 2009 in response to the global financial crisis as a way of strengthening the IMF's crisis prevention toolkit and bolstering confidence in qualifying members. They play a useful role in the global financial safety net while complementing the efforts of countries to further strengthen the resilience of their economies. EU Member States have pointed to the need for the IMF to remain strong and adequately resourced, and affirmed the importance of the IMF as a quota-based institution. However, far-reaching reforms of the Fund's quotas and governance agreed in 2010 remain pending, holding up discussions on the next General Review of Quotas. All EU Member States have ratified the 2010 Quota and Governance Reform and consider the implementation of these reforms by all IMF members a priority. IMF members also considered a possible direction for reform of the Fund's lending framework in the context of sovereign debt vulnerabilities. From an EU perspective, any changes should aim to strengthen the Fund's lending framework.

8.2.3 Technical cooperation

The ECB continued to broaden its technical cooperation with central banks outside the EU, with a focus on central banks in countries that have the prospect of joining the EU and in G20 emerging market economies. In the former case, the cooperation aims to enhance the technical readiness of central banks to assume the roles and obligations of a future ESCB member. The ECB has launched a Eurosystem cooperation programme offering a needs analysis with the Central Bank of Montenegro and another with the Bank of Albania, the Central Bank of the Republic of Kosovo and the National Bank of the Republic of Macedonia. These activities are implemented jointly with the NCBs and are funded by the EU. Technical cooperation complements the ECB's regular monitoring and analysis of EU candidate and potential candidate countries and the policy dialogue with their central banks. In addition, the ECB started to organise regional seminars on issues of mutual interest. Furthermore, the ECB and the National Bank of Serbia in July signed a Cooperation Agreement for the prevention and detection of counterfeit euro banknotes in Serbia. In a global context, the ECB continued to develop its cooperation with G20 emerging market economies on the basis of Memoranda of Understanding. These activities have a technical as well as a policy component, aiming to support a better understanding of ECB policies and to share technical expertise and best practices in central banking.

9 External communication

Explaining monetary policy and banking supervision to European citizens

Today central bank communication is right at the heart of monetary policy; indeed, it is a monetary policy tool in itself. A transparent central bank can implement its policy more effectively. If the general public and financial markets can understand how the ECB is likely to respond in a given situation, they can form reasonable expectations about future monetary policy. This allows changes in monetary policy to rapidly feed into financial variables, which in turn can shorten the process whereby monetary policy is transmitted to investment and consumption decisions and accelerate any necessary economic adjustments.

The ECB's communication in 2014 was shaped in particular by the need to communicate monetary policy in challenging times and to build the SSM.

Building trust: communicating monetary policy

Building trust among the 338 million citizens of the euro area is a major communication challenge. The ECB operates as of 1 January 2015 across 19 countries using 16 different languages. It deals with this plurality by making use of the inherent advantage of having 19 national central banks in the Eurosystem – that is, having colleagues in each country that can ensure that the ECB's messages are heard and understood in the local context. The ECB also plays its part in building trust by opening up to the public. From the outset, the ECB has taken a lead in terms of transparency. It was the first major central bank to offer regular press conferences after every monetary policy meeting. Every month, the ECB receives and answers roughly 4,000 enquiries from the general public. But in these challenging times, when monetary policy has to make use of unconventional tools, the ECB cannot stand still. At the start of 2015 the ECB began publishing accounts of the monetary policy meetings of the Governing Council. This is an additional way to explain the ECB's actions and the discussions that inspired them.

Accountability and transparency: implementing the guiding principles of the ECB's communication

The ECB's communication activities focused on the ECB's accommodative monetary policy and the preparations to assume responsibility for banking supervision. The vast majority of public speeches delivered by members of the Executive Board were related to these issues.

ECB on Twitter
@ecb

4,840 tweets
197,000 followers

The Executive Board further contributed to enhancing public knowledge and understanding of the Eurosystem's tasks and policies by giving testimony before the European Parliament and granting interviews to the media. In terms of direct outreach to the public, the ECB launched a new banking supervision website and made greater use of social media. The ECB used its website to publish simple series of questions and answers on relevant topics, for instance on the expanded asset purchase programme and the negative deposit rate. The ECB's Twitter account now has around 200,000 followers and is used to highlight publications and key messages from speeches, while YouTube is used to publish video content and Flickr for photographs.

Explaining monetary policy: the Sintra conference

The first ECB Forum on Central Banking, held in Sintra, Portugal, from 25 to 27 May 2014, brought together central bankers, academics and government officials to discuss current economic issues in the euro area. Hailed as the key European policy conference, it is already established as a major annual event. In 2015 the ECB Forum on Central Banking will be held from 21 to 23 May, also in Sintra.

Explaining our money: the new euro banknotes

Communication activities in 2014 also focused on euro banknotes, in particular in relation to the preparations for the changeover in Lithuania and the issuance of the new €10 banknote, which was the second denomination of the new series of euro banknotes to be introduced. The ECB implemented a number of communication measures aimed at informing the general public and cash handlers about the new banknote and its updated security features.

Building the SSM: a communication challenge

The year-long process of launching the SSM and a simultaneous health check of the banks to be supervised at times resembled a marathon. A year of communication challenges culminated with the publication of the results of the comprehensive assessment, an in-depth examination of 130 banks, on 26 October 2014 and with the official starting date of the ECB's banking supervision a few days later. These challenges ranged from aligning messages among 18 different national supervisory authorities to developing relations with a new audience of banking supervision journalists unfamiliar with the ECB, as well as explaining the technical details and reasoning underlying this huge exercise.

Cutting through complexity

As part of the drive to be as transparent as possible on how exactly the banks were examined, the ECB published all the related technical manuals. These were explained in regular technical briefings as well as in an animated video explaining the disclosure manuals.

Reaching diverse stakeholders

Financial markets naturally watched the outcome of the comprehensive assessment very closely. This meant that the ECB had to ensure that analysts were well informed at all times. Almost 200 analysts participated in a conference call with ECB experts on the day that the results of the comprehensive assessment were released.
The ECB also organised public consultations aimed at the general public and interested stakeholders, as required by the SSM Regulation, and liaised frequently and closely with counterparts at the European Banking Authority, the European Securities and Markets Authority, and the banks themselves. Academics and think tanks were also the focus of various briefing activities in several European capitals and in the United States throughout the year.

Annual Accounts

2014

Management report for the year ending 31 December 2014

1 Purpose of the ECB's management report

This management report is an integral part of the ECB's annual financial reporting. It provides contextual information that enables readers to better understand the business of the ECB, its operational framework and the impact of the ECB's operations on its financial statements.

This report provides information on the key resources and processes of the ECB, including information on corporate governance. In addition, given that the ECB's activities and operations are undertaken in support of its monetary policy objectives, its financial outcome should be viewed in conjunction with its policy actions. This report therefore also provides information on the ECB's main risks and how they are affected by its operations, as well as on the available financial resources and the impact of the ECB's key activities on its financial statements.

2 Key objectives and tasks

The ECB's primary objective is to maintain price stability. Its main tasks, as described in the Statute of the ESCB, comprise the implementation of the monetary policy of the European Union, the conduct of foreign exchange operations, the management of the official foreign reserves of the euro area countries and the promotion of the smooth operation of payment systems.

Furthermore, on 4 November 2014 the ECB assumed its banking supervision tasks with the objective of protecting the safety and soundness of credit institutions and the stability of the financial system of the European Union.

3 Key resources and processes

3.1 Governance of the ECB

The Executive Board, the Governing Council and the General Council are the decision-making bodies of the ECB.[1] In addition, the corporate governance of the ECB includes a high-level Audit Committee and a number of internal and external control layers.

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1 Further information on the decision-making bodies of the ECB is provided on the ECB's website (https://www.ecb.europa.eu/ecb/orga/decisions/govc/html/index.en.html).

3.1.1 Audit Committee

In order to further strengthen the corporate governance of the ECB and the Eurosystem, the Audit Committee provides assistance to the Governing Council regarding its responsibilities in respect of the integrity of financial information, the oversight of internal controls, compliance with applicable laws, regulations and codes of conduct, and the performance of the audit functions of the ECB and the Eurosystem. In particular, the Audit Committee, in accordance with its mandate, assesses the ECB's Annual Accounts and considers whether they provide a true and fair view and were drawn up in accordance with approved accounting rules. The Audit Committee is chaired by Erkki Liikanen (Governor of Suomen Pankki – Finlands Bank) and comprises two other Governing Council members (Vítor Constâncio and Christian Noyer) as well as two external members (Hans Tietmeyer and Jean-Claude Trichet).

3.1.2 External control layers

The Statute of the ESCB provides for two layers of external controls, namely the external auditors appointed to audit the Annual Accounts of the ECB and the European Court of Auditors, which examines the operational efficiency of the management of the ECB. The reports of the European Court of Auditors, together with the ECB's reply, are published on the ECB's website[2] and in the Official Journal of the European Union. In order to reinforce public assurance as to the independence of the ECB's external auditors, the principle of audit firm rotation every five years is applied. Good practices for selecting external auditors and determining their mandate provide high-level guidance for Eurosystem central banks. They also enable the Governing Council to formulate its recommendations to the EU Council on the basis of harmonised, consistent and transparent selection criteria. In 2013 Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft was appointed as the external auditors of the ECB until the end of the financial year 2017.

3.1.3 Internal control layers

A three-tier system of internal controls has been established at the ECB consisting of, first, management controls, second, various risk and compliance oversight functions and, third, independent audit assurance.

Resource controlling

Within the ECB's internal control structure, responsibility and accountability for budget matters lies primarily with the individual business areas. The Budget, Controlling and Organisation Division (BCO) of the Directorate General Human Resources, Budget and Organisation develops the framework for and prepares and

2 See http://www.ecb.europa.eu/ecb/orga/governance/html/index.en.html

monitors strategic planning in respect of the ECB's resources, as well as the related operational budget. These tasks are carried out in cooperation with the business areas, while applying the separation principle,[3] and the outcome is reflected in the annual work programmes of the divisions. BCO also provides planning and resource controlling, cost-benefit analysis and investment analysis for ECB and ESCB projects. Spending against agreed budgets is monitored regularly by the Executive Board, taking into account the advice of BCO, and by the Governing Council with the assistance of the Budget Committee (BUCOM), which is composed of ECB and euro area NCB experts. In accordance with Article 15 of the ECB's Rules of Procedure, BUCOM supports the Governing Council by providing a detailed evaluation of the ECB's annual budget proposals and of requests for supplementary budget funding by the Executive Board, prior to their submission to the Governing Council for approval.

Financial risk oversight functions

With regard to financial risks, the ECB's Directorate Risk Management is responsible for proposing policies and procedures that ensure an appropriate level of protection against financial risks for (a) the Eurosystem, including the ECB, in the conduct of monetary policy operations, and (b) the ECB in the management of its foreign reserves, gold and euro-denominated investment portfolios. The Directorate Risk Management also assesses and proposes improvements to the Eurosystem's monetary and foreign exchange policy operational frameworks from a risk management perspective. Furthermore, the Risk Management Committee (RMC), which comprises experts from Eurosystem central banks, assists the decision-making bodies in ensuring an appropriate level of protection for the Eurosystem by managing and controlling the financial risks originating from its market operations, in the context of both the Eurosystem's monetary policy operations and the ECB's foreign reserves portfolio. With regard to these activities, the RMC contributes inter alia to the monitoring, measuring and reporting of financial risks in the Eurosystem balance sheet and the definition and review of the associated methodologies and frameworks.

Operational risk oversight functions

Under the operational risk management (ORM) framework, each organisational unit of the ECB is responsible for managing its own operational risks and implementing its own controls in order to ensure the effectiveness and efficiency of its operations. The Operational Risk Committee is responsible for the definition and maintenance of the ORM framework, providing methodological support and training, and establishing an ECB-wide overview of risks. The Operational Risk Committee supports the Executive Board in its oversight role in respect of the management of the ECB's operational risks. Furthermore, the Organisational Development Committee, which comprises experts from Eurosystem central banks, provides a second layer of control in the

3 The separation principles refers to the requirement as laid down in the SSM Regulation for the ECB to carry out its supervisory tasks without prejudice to and separately from its tasks relating to monetary policy and any other tasks.

context of operational risk management at the Eurosystem level and assists the decision-making bodies in their task of ensuring an appropriate level of protection for the Eurosystem.

Independent assurance

In addition, and independently of the internal control structure and risk monitoring of the ECB, the Directorate Internal Audit performs audit missions under the direct responsibility of the Executive Board. In accordance with the mandate defined in the ECB's Audit Charter, the ECB's internal auditors provide independent and objective assurance and consulting services, bringing a systematic approach to evaluating and improving the effectiveness of risk management, control and governance processes. The ECB's internal audit activities conform to the International Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors. Furthermore, a Eurosystem/ESCB committee, the Internal Auditors Committee, which is composed of internal audit experts from the ECB, the NCBs and the national competent authorities, assists in the achievement of the objectives of the Eurosystem/ESCB and Single Supervisory Mechanism (SSM) by providing independent, objective assurance and consulting services designed to add value and to improve the Eurosystem/ESCB and SSM.

3.1.4 Anti-fraud measures

In 1999 the European Parliament and the EU Council adopted a Regulation[4] to allow for, inter alia, the internal investigation by the European Anti-Fraud Office (OLAF) of suspected fraud within the EU institutions, bodies, offices and agencies. In 2004 the Governing Council endorsed the legal framework covering the terms and conditions for investigations by OLAF of the ECB in relation to the prevention of fraud, corruption and any other illegal activities.

3.1.5 Anti-money laundering/counter-terrorist financing programme

In 2007 the ECB established its internal anti-money laundering (AML) and counter-terrorist financing (CTF) schemes. A compliance function within the ECB identifies, analyses and addresses the risks associated with money laundering and terrorist financing for all relevant activities of the ECB. In particular, ensuring compliance with applicable AML/CTF legislation is part of the process of assessing and monitoring the eligibility of the ECB's counterparties. In this context, particular attention is paid to restrictive measures adopted by the EU and public statements issued by the Financial Action Task Force. An internal reporting system complements the ECB's AML/CTF framework to ensure that all relevant information is systematically collected and duly communicated to the Executive Board.

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[4] Regulation (EC) No 1073/1999.

3.2 Employees

The preparations for the launch of the SSM on 4 November 2014 had a major impact on staffing at the ECB. The average number of staff (full-time equivalents) holding contracts with the ECB rose from 1,683 in 2013 to 2,155 in 2014. At the end of 2014 2,577 staff members were employed. For further information, see note 31, "Staff costs", of the Annual Accounts.

The two-year career transition support programme, launched in January 2013, came to a successful end, with 45 members of staff taking up the support provided to pursue careers outside the ECB.

3.3 Portfolio management

The ECB holds two types of investment portfolio, namely the foreign reserves investment portfolio, denominated in US dollars and Japanese yen, and an own funds investment portfolio, denominated in euro. In addition, the funds relating to the ECB's pension plans are invested in an externally managed portfolio. The ECB also holds euro-denominated securities for monetary policy purposes, acquired in the context of the Securities Markets Programme (SMP), the asset-backed securities purchase programme (ABSPP) and the three covered bond purchase programmes (CBPP).

3.4 Production of the ECB's financial accounts

The Annual Accounts of the ECB are drawn up by the Executive Board, in accordance with the accounting policies established by the Governing Council.[5]

The Financial Reporting and Policy Division of the Directorate General Administration is responsible for producing the Annual Accounts in cooperation with other business areas and for ensuring that all related documentation is made available in a timely manner to the external auditors and to the decision-making bodies.

The ECB's Assets and Liabilities Committee, which is composed of representatives from the ECB's market operations, accounting, financial reporting, risk management and budget functions, systematically monitors and assesses all factors that may have a bearing on the ECB's Balance Sheet and Profit and Loss Account. It reviews the Annual Accounts and the related documentation before they are submitted to the Executive Board for endorsement.

The financial reporting processes and the ECB's Annual Accounts may be subject to internal audits. All internal audit reports, which may include audit recommendations addressed to the business areas concerned, are submitted to the Executive Board.

5 See the notes on accounting policies.

Furthermore, the Annual Accounts of the ECB are audited by independent external auditors recommended by the Governing Council and approved by the EU Council. The external auditors examine the books and accounts of the ECB and have full access to all information about its transactions. The responsibility of the external auditors is to express an opinion as to whether the Annual Accounts give a true and fair view of the financial position of the ECB and of the results of its operations, in accordance with the accounting policies established by the Governing Council. In this regard, the external auditors evaluate the adequacy of internal controls applied to the preparation and presentation of the Annual Accounts and assess the appropriateness of the accounting policies used.

After the Executive Board has authorised their issuance, the Annual Accounts, together with the external auditors' opinion and all relevant documentation, are submitted to the Audit Committee for review prior to their submission to the Governing Council for approval.

The ECB's Annual Accounts are approved by the Governing Council in February of each year and published immediately thereafter. From 2015 the Annual Accounts will be published together with the management report and the consolidated balance sheet of the Eurosystem.

4 Risk management

The ECB is exposed to both financial and operational risks. Risk management is therefore a critical component of its activities and is conducted through a continuous process of risk identification, assessment, mitigation and monitoring.

4.1 Financial risks

Financial risks arise from the ECB's core activities and associated exposures, in particular its (a) foreign reserves and gold, (b) euro-denominated investment portfolios, and (c) holdings of securities purchased for monetary policy purposes within the scope of the three CBPPs, the SMP and the ABSPP. Financial risks arising from these exposures and activities encompass credit, market and liquidity risks. The ECB decides its asset allocation and implements appropriate risk management and due diligence frameworks, taking into account the objectives and purposes of the various portfolios and the financial exposures, as well as the risk preferences of its decision-making bodies. To ensure such preferences are met at all times, the ECB monitors and measures risks on a regular basis, takes appropriate risk mitigation actions when needed and regularly reviews its asset allocation as well as its risk management frameworks.

Financial risks can be quantified using a variety of risk measures. In order to estimate such risks, the ECB applies risk estimation techniques developed in-house, which rely on a joint market and credit risk simulation framework. The core modelling concepts, techniques and assumptions underlying the risk measures draw on market standards.[6] In order to obtain a comprehensive understanding of potential risk events that could occur at different frequencies with different degrees of severity, the ECB uses two types of statistical measure, Value at Risk (VaR) and Expected Shortfall,[7] which are calculated for a number of confidence levels. Furthermore, sensitivity and stress scenario analyses are used to better understand and complement the statistical risk estimates.

Measured as VaR at a 95% confidence level over a one-year horizon (VaR95%), as at 31 December 2014 the financial risks to which the ECB was exposed through its financial assets amounted to a total of €8.6 billion, which was unchanged compared with the aggregate risks estimated as at 31 December 2013.[8]

4.1.1 Credit risk

The ECB manages its credit risk, which comprises credit default and credit migration risks,[9] mainly through its asset allocation policies, eligibility criteria, due diligence assessments, systems of exposure limits and, in certain credit operations, also by means of collateralisation techniques. The risk controls and limits that the ECB uses to determine its credit risk exposure differ across types of operation, reflecting the policy or investment objectives of the different portfolios and the risk characteristics of the underlying assets.

The ECB's foreign reserves holdings are subject to both credit default and credit migration risks. However, these risks are minimal, as the reserves are invested in assets with a high credit quality.

The ECB's holdings of gold are not subject to credit risk, as gold is not lent to third parties.

The purpose of the euro-denominated investment portfolio is to provide the ECB with income to help cover its operating expenses, while preserving the invested capital. Return considerations therefore play a relatively greater role in the asset allocation and risk control framework for these holdings than they do for the ECB's foreign

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6 Default and rating migration probabilities are derived from default and rating transition studies published by the major rating agencies. Volatilities, correlations and, more generally, the co-movement of credit and market risk variables are modelled by means of a multi-factor copula approach, calibrated on the basis of historical data.

7 Value at Risk (VaR) is defined as the maximum potential loss threshold for the portfolio of financial assets that, according to a statistical model, will not be exceeded with a given probability (confidence level) over a specified risk horizon. Expected Shortfall is a coherent risk measure that is more conservative than VaR when using the same horizon and the same confidence level, as it measures the probability-weighted average losses that could occur in the worst-case scenarios that exceed the VaR threshold. Losses, in this context, are defined as differences between the net worth of the ECB's portfolios as stated on the Balance Sheet at the beginning of the horizon, compared with simulated values at the end of the horizon.

8 Risk estimates provided in this management report have been produced using a consistent set of methodologies and assumptions for exposures measured as at 31 December 2013 and 31 December 2014.

9 Credit default risk is defined as the risk of incurring financial losses owing to a "default event" which stems from the failure of an obligor (counterparty or issuer) to meet its financial obligations in a timely manner. Credit migration risk is the risk of incurring financial losses owing to a re-pricing of financial assets following a deterioration in their credit quality and ratings.

reserves. Notwithstanding, the credit risk in respect of these holdings is kept at moderate levels.

The securities acquired for monetary policy purposes within the scope of the CBPP, the SMP and the ABSPP are valued at amortised cost subject to impairment and are therefore not revalued at market prices. As a consequence, credit migration risk associated with these exposures does not directly affect the financial accounts of the ECB. However, these securities may be subject to credit default risk and a deterioration in their credit quality can affect the financial accounts of the ECB through the regular process of analysis and recognition of impairments. In the case of the SMP, the credit risk profile is determined by the allocation of past purchases across countries, which was driven by monetary policy considerations. In the case of the three CBPP portfolios, the credit default risk is kept at moderate levels through the asset allocation policies, exposure limits and eligibility frameworks, which result in a diversified portfolio of covered bonds with a high credit quality. The credit default risk associated with the ABSPP is managed via a comprehensive due diligence process that complements the applied eligibility criteria, ensuring that only high-quality, simple and transparent asset-backed securities are purchased. The resulting level of credit risk associated with securities held for monetary policy purposes is within the tolerance levels of the ECB.

4.1.2 Market risk[10]

The main types of market risk to which the ECB is subject in managing its holdings are currency and commodity (gold price) risks.[11] The ECB is also exposed to interest rate risk.[12]

Currency and commodity risks

The ECB is exposed to currency risks and commodity risks owing to its holdings of foreign reserves and gold. Given the size of its exposure and the volatility of exchange rates and gold prices, currency and commodity risks dominate the ECB's financial risk profile.

In view of the policy role of gold and foreign reserves, the ECB does not seek to eliminate currency and commodity risks. These risks are largely mitigated by the diversification of the holdings across different currencies and gold, even though the asset allocation is primarily driven by the potential need for policy interventions.

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[10] Market risk is the risk of incurring financial losses owing to movements in market prices and interest rates that are not related to credit events.

[11] Currency risk is the risk of incurring financial losses on positions denominated in foreign currency, owing to fluctuations in exchange rates. Commodity risk is the risk of incurring financial losses on holdings of commodities, owing to fluctuations in their market prices.

[12] Interest rate risk is defined as the risk of incurring financial losses owing to a mark-to-market decline in the value of financial instruments as a result of adverse changes in applicable interest rates (yields).

The contributions of currency and commodity risks dominate the ECB’s total risk profile. The bulk of the risks stem from the volatility of gold prices and of the US dollar exchange rate. In line with the Eurosystem rules, the gold and US dollar revaluation accounts, which amounted to €12.1 billion (2013: €10.1 billion) and €6.2 billion (2013: €1.7 billion) respectively as at 31 December 2014, can be used to absorb the impact of future unfavourable movements in the prices of the underlying assets, thereby mitigating or even preventing any impact on the ECB’s Profit and Loss Account.

Interest rate risk

Securities acquired within the scope of the three CBPPs, the SMP and the ABSPP are valued at amortised cost subject to impairment and are therefore not revalued at market prices. Thus, they are not directly exposed to interest rate risk.

Conversely, the bulk of the ECB’s foreign reserves and euro-denominated investment portfolios is invested in fixed income securities which are revalued at market prices and are therefore exposed to interest rate risk. The interest rate risk arising from these portfolios is managed through asset allocation policies and market risk limits which ensure that the market risk remains contained at levels that reflect the ECB’s risk-return preferences for the different portfolios. When expressed in terms of the modified duration[13] of the fixed income portfolios, the different risk-return preferences result in a longer modified duration for the euro-denominated investment portfolio than for the foreign reserves holdings.

The interest rate risk to which the ECB is exposed is limited, and it remained broadly stable at low levels over the course of 2014.

4.1.3 Liquidity risk

In view of the role of the euro as a major reserve currency, the ECB’s role as a central bank and its asset and liability structure, the only significant liquidity risk that the ECB is subject to is the risk of incurring financial losses owing to the inability to liquidate an asset at its prevailing market value within an appropriate time frame. In this regard, given the stability of the ECB’s portfolios and their distinct objectives, the ECB’s main exposure to liquidity risk stems from its foreign reserves, as, in order to carry out foreign exchange interventions, large amounts of these holdings may have to be liquidated within short periods of time.

The liquidity risk in respect of the ECB’s foreign reserves is managed by establishing an asset allocation and limits which ensure that a sufficiently large share of the ECB’s holdings are invested in assets that can be liquidated quickly with a negligible impact on the price.

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13 Modified duration is a measure of the sensitivity of the value of the portfolios to parallel shifts in yield curves.

The liquidity risk profile of the ECB's portfolios remained broadly stable in 2014.

4.2 Operational risk

Within the ECB, operational risk is defined as the risk of a negative financial, business or reputational impact resulting from people,[14] the inadequate implementation or failure of internal governance and business processes, the failure of systems on which processes rely, or external events (e.g. natural disasters or external attacks). The main objectives of ORM at the ECB are (a) to contribute to ensuring that the ECB achieves its mission and objectives; and (b) to protect its reputation and other assets against loss, misuse and damage.

Under the ORM framework, each business area is responsible for identifying, assessing, responding to, reporting on and monitoring its operational risks. In this context, the ECB's risk tolerance policy provides guidance with regard to risk response strategies and risk acceptance procedures. It is linked to a risk matrix based on the ECB's impact and likelihood grading scales (which apply quantitative and qualitative criteria).

The ORM/BCM function is responsible for maintaining the ORM and business continuity management (BCM) frameworks and providing methodological assistance in respect of ORM and BCM activities to risk owners. Moreover, it provides annual and ad-hoc reports on operational risks to the Operational Risk Committee and the Executive Board and it supports the decision-making bodies in their oversight role regarding the management of the ECB's operational risks. It coordinates and implements the BCM programme, conducting regular tests and reviews of business continuity arrangements for the ECB's critical operations and supporting the Crisis Management Team, its support structures and business areas in the event of severe business disruption.

5 Financial resources

5.1 Capital

As a consequence of Latvia's adoption of the single currency on 1 January 2014, Latvijas Banka paid an amount of €29.4 million as at that date. As a result of this payment, as well as the adjustment of the NCBs' weightings in the ECB's capital key, the ECB's paid-up capital amounted to €7,697 million on 31 December 2014. Detailed information on the capital of the ECB is provided in note 16.1, "Capital", of the Annual Accounts.

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14 The term "people" is used in a broad sense and covers any negative impact resulting from actions of the workforce, as well as from deficient personnel resourcing and personnel policies.

5.2 Provision for foreign exchange rate, interest rate, credit and gold price risks

In view of the ECB's considerable exposure to financial risks as outlined in Section 4, the ECB maintains a provision for foreign exchange rate, interest rate, credit and gold price risks. The size of and continuing requirement for this provision is reviewed annually, taking a range of factors into account, including in particular the level of holdings of risk-bearing assets, the extent of materialised risk exposures in the current financial year, projected results for the coming year and a risk assessment involving calculations of Values at Risk (VaR) on risk-bearing assets, which is applied consistently over time. The risk provision, together with any amounts held in the ECB's general reserve fund, may not exceed the value of the capital paid up by the euro area NCBs.

As at 31 December 2013 the provision for foreign exchange rate, interest rate, credit and gold price risks amounted to €7,530 million. Latvijas Banka contributed an amount of €30.5 million with effect from 1 January 2014. After taking the results of its risk assessment into account, the Governing Council decided to increase the size of the risk provision to €7,575 million as at 31 December 2014. This amount equates to the value of the ECB's capital paid up by the euro area NCBs as at 31 December 2014.

5.3 Revaluation accounts

Unrealised gains on gold, foreign currencies and securities, with the exception of those valued at amortised cost, are not recognised as income in the Profit and Loss Account but are transferred directly to revaluation accounts shown on the liability side of the ECB's Balance Sheet. These balances can be used to absorb the impact of any future unfavourable movements in the prices and/or exchange rates, and therefore constitute a financial buffer that strengthens the ECB's resilience to the underlying risks.

The total amount of revaluation accounts for gold, foreign currencies and securities as at the end of December 2014 stood at €20.2 billion.[15] For further information, see the notes on accounting policies and note 15, "Revaluation accounts", in the notes on the Balance Sheet.

15 In addition, the balance sheet item "Revaluation accounts" also includes remeasurements in respect of post-employment benefits.

6 Impact of key activities on financial statements

The table provides an overview of the main operations and functions of the ECB in pursuit of its mandate, and their impact on the ECB's financial statements.

Operation/Function	Impact on the ECB's Annual Accounts
Monetary policy operations	Standard monetary policy operations are implemented in a decentralised manner by the NCBs of the Eurosystem. Consequently, these operations have no direct impact on the ECB's Annual Accounts.
Securities held for monetary policy purposes (CBPPs, SMP and ABSPP)	Securities purchased by the ECB are recorded under the item "Securities held for monetary policy purposes". Holdings in these portfolios are accounted for at amortised cost and an impairment test is conducted at least annually. Coupon accruals and amortisation of discounts/premiums are included in the Profit and Loss Account.[16]
Investment activities (management of foreign reserves and own funds)	The foreign reserves of the ECB are presented on-balance sheet[17] or are reflected in off-balance-sheet accounts until the settlement date. The own funds portfolio of the ECB is presented on-balance sheet, mainly under the item "Other financial assets". Net interest income, including coupon accruals and the amortisation of discounts/premiums, is included in the Profit and Loss Account.[18] Unrealised price and exchange rate losses, as well as realised gains and losses arising from the sale of securities, are also included in the Profit and Loss Account,[19] while unrealised gains are recorded on-balance sheet under the item "Revaluation accounts".
Payment systems (TARGET2)	Intra-Eurosystem balances of euro area NCBs vis-à-vis the ECB arising from TARGET2 are presented on the Balance Sheet of the ECB as a single net asset or liability position. The remuneration of those balances is included in the Profit and Loss Account under the items "Other Interest Income" and "Other Interest Expense".
Banknotes in circulation	The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation. This share is backed by claims on the NCBs, which bear interest at the rate on the main refinancing operations. This interest is included in the Profit and Loss Account under the item "Interest income arising from the allocation of euro banknotes within the Eurosystem". Expenses arising from the cross-border transportation of euro banknotes between banknote printing works and NCBs, for the delivery of new banknotes, and between NCBs, for the compensation of shortages with surplus stocks, are borne centrally by the ECB. These expenses are presented in the Profit and Loss Account under the heading "Banknote production services".
Banking supervision	The annual costs of the ECB in relation to its supervisory tasks are recovered via the annual supervisory fee levied on the supervised entities. Since the beginning of November 2014 supervisory fees have been recorded on an accrual basis in the Profit and Loss Account under the heading "Net income from fees and commissions".

16 Under the items "Other Interest Income" and "Other Interest Expense".

17 Mainly under "Gold and gold receivables", "Claims on non-euro area residents denominated in foreign currency", "Claims on euro area residents denominated in foreign currency" and "Liabilities to non-euro area residents denominated in foreign currency".

18 Income related to the ECB's foreign reserves is disclosed under the item "Interest income on foreign reserve assets", while the interest income and expenses on own funds are reflected in "Other interest income" and "Other interest expense".

19 Under the items "Write-downs on financial assets and positions" and "Realised gains/losses arising from financial operations".

7 Financial result for 2014

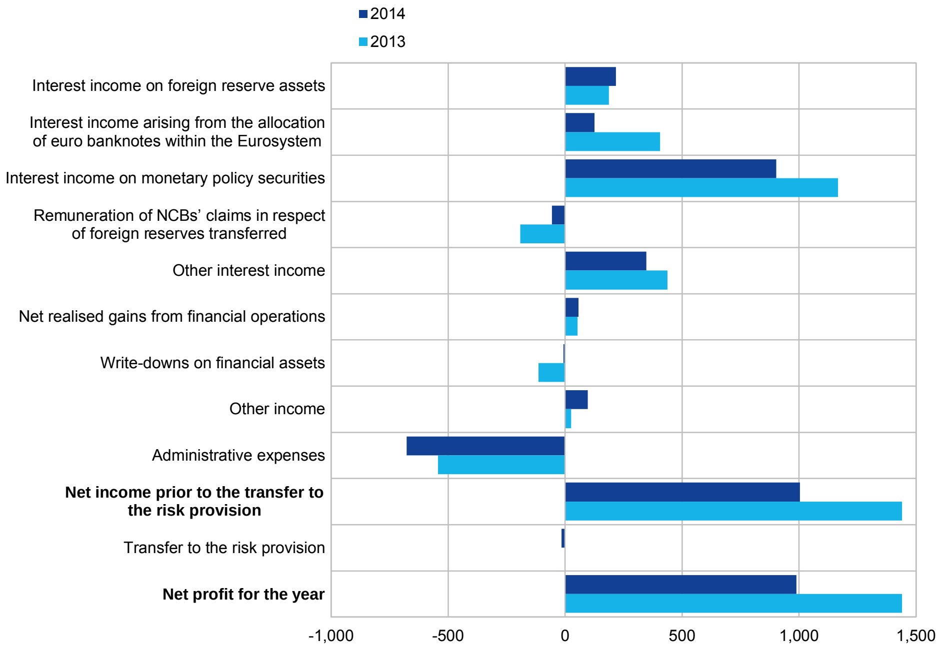
In 2014 the ECB's net profit was €989 million (2013: €1,440 million) after a transfer to the risk provision of €15 million (2013: €0.4 million).

Chart 1 presents the components of the ECB's Profit and Loss Account in 2014 and a comparison with 2013.

Chart 1

Breakdown of the ECB's Profit and Loss Account in 2014 and 2013

(EUR millions)



Source: ECB.

Key highlights

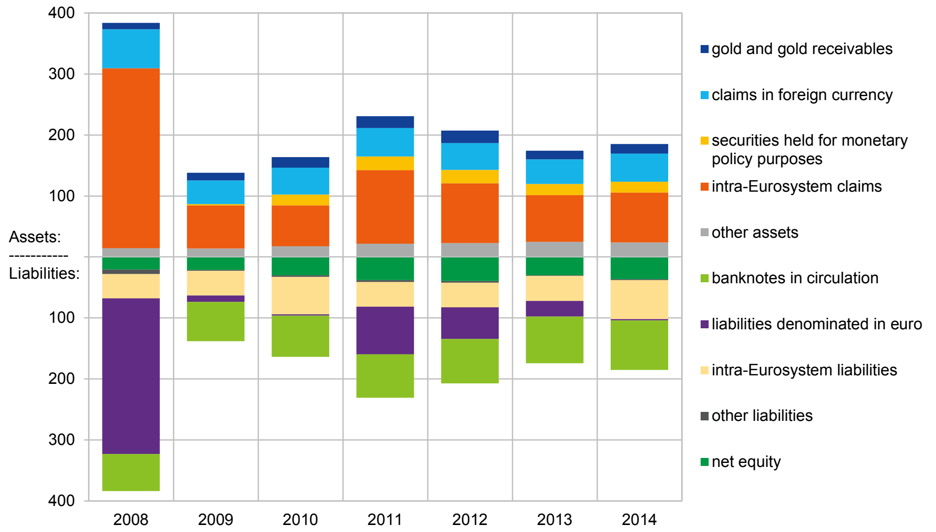
- In 2014 net interest income decreased to €1,536 million, compared with €2,005 million in 2013, due mainly to (a) the lower interest income on the ECB's share of the total euro banknotes in circulation as a result of the lower average rate on the main refinancing operations in 2014; and (b) a decrease in interest income generated on the securities purchased under the Securities Markets Programme and the first and second covered bond purchase programmes, as a result of the maturing of securities. The effects of these developments were partially offset by the lower interest expense arising from the euro area NCBs' claims in respect of the foreign reserve assets transferred by them to the ECB.
- In 2014 the overall increase in the market value of securities held in both the US dollar and the own funds portfolios resulted in substantially lower write-downs in that year, amounting to €8 million (2013: €115 million).
- The total administrative expenses of the ECB, including depreciation, amounted to €677 million in 2014, compared with €527 million in 2013. This increase was mainly due to expenses incurred in connection with the Single Supervisory Mechanism. The vast majority of the costs incurred in connection with the construction of the ECB's new premises have been capitalised and are excluded from this item.
- In November 2014 the ECB moved into its new premises. Consequently, the capitalised expenditure incurred up to that point was transferred from "Assets under construction" to the appropriate asset headings. Depreciation commenced in January 2015, in line with the ECB's depreciation policy.
- A change in the accounting policy: as outlined in the notes on accounting policies, the treatment of securities currently held for monetary policy purposes has been modified. These securities are now accounted for at amortised cost subject to impairment, regardless of the holding intention. This change had no impact on the ECB's financial result.

8 Long-term developments in the ECB's financial statements

Charts 2 and 3 present the evolution of the Balance Sheet and Profit and Loss Account of the ECB, as well as their components, over the period 2008-14.

Chart 2
Evolution of the ECB's Balance Sheet in the period 2008-14

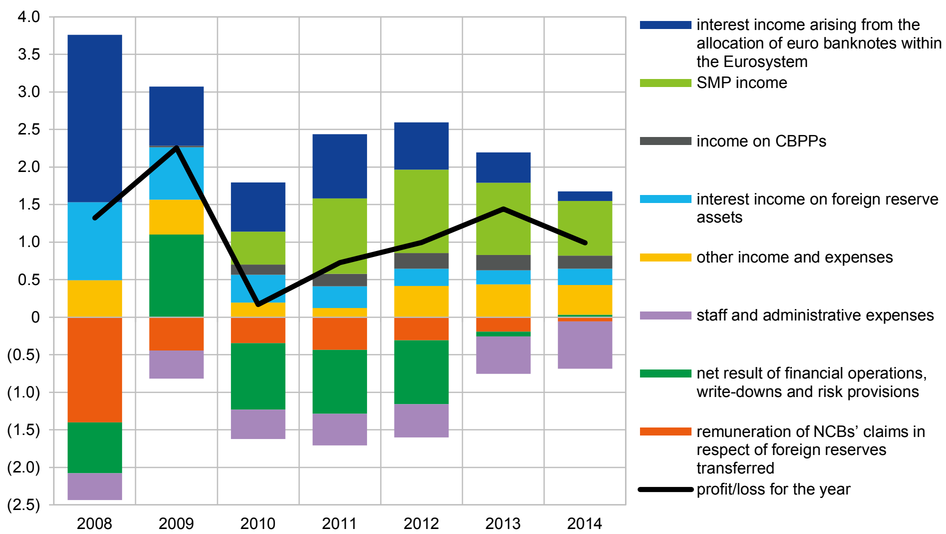
(EUR billions)



Source: ECB.

Chart 3
Evolution of the ECB's Profit and Loss Account in the period 2008-14

(EUR billions)



Source: ECB.

The ECB's Balance Sheet has contracted significantly since 2008. The improvement in the US dollar funding conditions for Eurosystem counterparties resulted in a gradual reduction in US dollar liquidity-providing operations offered by the Eurosystem. The concomitant reduction in the intra-Eurosystem claims of the ECB and its liabilities denominated in euro was the main factor in the overall reduction of the ECB's Balance Sheet over this period. This decrease was only partially offset by (a) the increase in banknotes in circulation; (b) the purchases of securities held for monetary policy purposes; and (c) the increase in net equity, consisting of the ECB's capital, its general risk provision and the revaluation accounts.

The size of the ECB's net profit over the same period was influenced by the following factors.

- The rate on the main refinancing operations decreased, significantly reducing the seigniorage income of the ECB. The average rate for 2014 was 0.16%, compared with 4% for 2008, and, as a result, interest income on banknotes in circulation fell from €2.2 billion in 2008 to €0.1 billion in 2014.
- The amount of €3.6 billion was transferred to the general risk provision for foreign exchange rate, interest rate, credit and gold price risks. Amounts transferred to this provision reduce the reported profit by an equivalent amount.
- The income earned on foreign reserve assets declined gradually, mainly owing to the reduction in US dollar yields and the resulting decrease in interest income generated on the US dollar portfolio. Net income on foreign reserve assets amounted to €0.2 billion in 2014, compared with €1.0 billion in 2008.
- Purchases of securities held for monetary policy purposes, in the context of the SMP and CBPP portfolios, have generated, on average, 55% of the ECB's overall net interest income over the last five years.

Financial statements of the ECB

Balance Sheet as at 31 December 2014

ASSETS	Note number	2014 €	2013 €
Gold and gold receivables	1	**15,980,317,601**	**14,063,991,807**
Claims on non-euro area residents denominated in foreign currency	2		
Receivables from the IMF	2.1	669,336,060	627,152,259
Balances with banks and security investments, external loans and other external assets	2.2	43,730,904,005	38,764,255,039
		44,400,240,065	**39,391,407,298**
Claims on euro area residents denominated in foreign currency	2.2	**1,783,727,949**	**1,270,792,764**
Claims on non-euro area residents denominated in euro	3		
Balances with banks, security investments and loans	3.1	**0**	**535,000,000**
Other claims on euro area credit institutions denominated in euro	4	**2,120,620**	**9,487**
Securities of euro area residents denominated in euro	5		
Securities held for monetary policy purposes	5.1	**17,787,948,367**	**18,159,937,704**
Intra-Eurosystem claims	6		
Claims related to the allocation of euro banknotes within the Eurosystem	6.1	**81,322,848,550**	**76,495,146,585**
Other assets	7		
Tangible and intangible fixed assets	7.1	1,249,596,659	971,175,790
Other financial assets	7.2	20,626,359,858	20,466,245,900
Off-balance-sheet instruments revaluation differences	7.3	319,624,726	104,707,529
Accruals and prepaid expenses	7.4	725,224,031	977,552,068
Sundry	7.5	1,092,627,246	1,739,308,724
		24,013,432,520	**24,258,990,011**
Total assets		**185,290,635,672**	**174,175,275,656**

LIABILITIES	Note number	2014 €	2013 €
Banknotes in circulation	8	**81,322,848,550**	**76,495,146,585**
Liabilities to other euro area residents denominated in euro	9		
Other liabilities	9.1	**1,020,000,000**	**1,054,000,000**
Liabilities to non-euro area residents denominated in euro	10	**900,216,447**	**24,765,513,795**
Liabilities to non-euro area residents denominated in foreign currency	11		
Deposits, balances and other liabilities	11.1	**458,168,063**	**18,478,777**
Intra-Eurosystem liabilities	12		
Liabilities equivalent to the transfer of foreign reserves	12.1	40,553,154,708	40,309,644,425
Other liabilities within the Eurosystem (net)	12.2	23,579,372,965	119,857,494
		64,132,527,673	**40,429,501,919**
Other liabilities	13		
Off-balance-sheet instruments revaluation differences	13.1	178,633,615	185,010,549
Accruals and income collected in advance	13.2	96,191,651	370,542,207
Sundry	13.3	869,549,503	786,331,706
		1,144,374,769	**1,341,884,462**
Provisions	14	**7,688,997,634**	**7,619,546,534**
Revaluation accounts	15	**19,937,644,696**	**13,358,190,073**
Capital and reserves	16		
Capital	16.1	**7,697,025,340**	**7,653,244,411**
Profit for the year		**988,832,500**	**1,439,769,100**
Total liabilities		**185,290,635,672**	**174,175,275,656**

Profit and Loss Account for the year ending 31 December 2014

	Note number	2014 €	2013 €
Interest income on foreign reserve assets	24.1	217,003,159	187,279,973
Interest income arising from the allocation of euro banknotes within the Eurosystem	24.2	125,806,228	406,310,130
Other interest income	24.4	2,512,243,088	6,477,297,658
Interest income		*2,855,052,475*	*7,070,887,761*
Remuneration of NCBs' claims in respect of foreign reserves transferred	24.3	(57,015,146)	(192,248,631)
Other interest expense	24.4	(1,262,336,836)	(4,873,777,652)
Interest expense		*(1,319,351,982)*	*(5,066,026,283)*
Net interest income	24	**1,535,700,493**	**2,004,861,478**
Realised gains/losses arising from financial operations	25	57,260,415	52,122,402
Write-downs on financial assets and positions	26	(7,863,293)	(114,607,365)
Transfer to/from provisions for foreign exchange rate, interest rate, credit and gold price risks		(15,009,843)	(386,953)
Net result of financial operations, write-downs and risk provisions		**34,387,279**	**(62,871,916)**
Net income/expense from fees and commissions	27, 28	**28,158,654**	**(2,126,773)**
Income from equity shares and participating interests	29	**780,935**	**1,168,907**
Other income	30	**67,253,502**	**26,107,807**
Total net income		**1,666,280,863**	**1,967,139,503**
Staff costs	31	(301,142,390)	(240,523,980)
Administrative expenses	32	(353,579,537)	(268,183,737)
Depreciation of tangible and intangible fixed assets		(15,312,728)	(10,468,686)
Banknote production services	33	(7,413,708)	(8,194,000)
Profit for the year		**988,832,500**	**1,439,769,100**

Frankfurt am Main, 10 February 2015

EUROPEAN CENTRAL BANK

Mario Draghi
President

Accounting policies[1]

Form and presentation of the financial statements

The financial statements of the ECB have been designed to present fairly the financial position of the ECB and the results of its operations. They have been drawn up in accordance with the following accounting policies,[2] which the Governing Council of the ECB considers to be appropriate to the nature of central bank activity.

Accounting principles

The following accounting principles have been applied: economic reality and transparency, prudence, recognition of post-balance-sheet events, materiality, going concern, the accruals principle, consistency and comparability.

Recognition of assets and liabilities

An asset or liability is only recognised in the Balance Sheet when it is probable that any associated future economic benefit will flow to or from the ECB, substantially all of the associated risks and rewards have been transferred to the ECB, and the cost or value of the asset or the amount of the obligation can be measured reliably.

Basis of accounting

The accounts have been prepared on a historical cost basis, modified to include the market valuation of marketable securities (other than securities held for monetary policy purposes), gold and all other on-balance-sheet and off-balance-sheet assets and liabilities denominated in foreign currency. Transactions in financial assets and liabilities are reflected in the accounts on the basis of the date on which they were settled.

With the exception of spot transactions in securities, transactions in financial instruments denominated in foreign currency are recorded in off-balance-sheet accounts on the trade date. At the settlement date the off-balance-sheet entries are reversed and transactions are booked on-balance-sheet. Purchases and sales of foreign currency affect the net foreign currency position on the trade date, and realised results arising from sales are also calculated on that date. Accrued interest, premiums and discounts related to financial instruments denominated in foreign

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1 The detailed accounting policies of the ECB are laid down in Decision ECB/2010/21 of 11 November 2010, OJ L 35, 9.2.2011, p. 1. This Decision was last amended by Decision ECB/2014/55 of 15 December 2014, OJ L 68, 13.3.2015, p. 54.

2 These policies are consistent with the provisions of Article 26.4 of the Statute of the ESCB, which require a harmonised approach to the rules governing the accounting and financial reporting of Eurosystem operations.

currency are calculated and recorded daily, and the foreign currency position is also affected daily by these accruals.

Gold and foreign currency assets and liabilities

Assets and liabilities denominated in foreign currency are converted into euro at the exchange rate prevailing on the balance sheet date. Income and expenses are converted at the exchange rate prevailing on the recording date. The revaluation of foreign exchange assets and liabilities, including on-balance-sheet and off-balance-sheet instruments, is performed on a currency-by-currency basis.

Revaluation to the market price for assets and liabilities denominated in foreign currency is treated separately from the exchange rate revaluation.

Gold is valued at the market price prevailing at the year-end. No distinction is made between the price and currency revaluation differences for gold. Instead, a single gold valuation is accounted for on the basis of the price in euro per fine ounce of gold, which, for the year ending 31 December 2014, was derived from the exchange rate of the euro against the US dollar on 31 December 2014.

The special drawing right (SDR) is defined in terms of a basket of currencies. To revalue the ECB's holdings of SDRs, the value of the SDR was calculated as the weighted sum of the exchange rates of four major currencies (the US dollar, euro, Japanese yen and pound sterling) converted into euro as at 31 December 2014.

Securities

Securities held for monetary policy purposes

Prior to 2014 all securities held for monetary policy purposes had been classified as held-to-maturity and were therefore valued at amortised cost subject to impairment. In 2014 the Governing Council decided that securities currently held for monetary policy purposes will be accounted for at amortised cost subject to impairment regardless of the holding intention. This change to the accounting policy did not result in an adjustment of the comparable figures for 2013 as all such existing securities were already valued at amortised cost subject to impairment.

Other securities

Marketable securities (other than securities held for monetary policy purposes) and similar assets are valued either at the mid-market prices or on the basis of the relevant yield curve prevailing on the balance sheet date, on a security-by-security basis. Options embedded in securities are not separated for valuation purposes. For the year ending 31 December 2014, mid-market prices on 30 December 2014 were used. Illiquid equity shares are valued at cost subject to impairment.

Income recognition

Income and expenses are recognised in the period in which they are earned or incurred.[3] Realised gains and losses arising from the sale of foreign currency, gold and securities are taken to the Profit and Loss Account. Such realised gains and losses are calculated by reference to the average cost of the respective asset.

Unrealised gains are not recognised as income but are transferred directly to a revaluation account.

Unrealised losses are taken to the Profit and Loss Account if, at the year-end, they exceed previous revaluation gains registered in the corresponding revaluation account. Such unrealised losses on any one security or currency or on gold are not netted against unrealised gains on other securities or currencies or gold. In the event of such unrealised loss on any item taken to the Profit and Loss Account, the average cost of that item is reduced to the year-end exchange rate or market price. Unrealised losses on interest rate swaps that are taken to the Profit and Loss Account at the year-end are amortised in subsequent years.

Impairment losses are taken to the Profit and Loss Account and are not reversed in subsequent years unless the impairment decreases and the decrease can be related to an observable event that occurred after the impairment was first recorded.

Premiums or discounts arising on purchased securities are calculated and presented as part of interest income and are amortised over the remaining contractual life of the securities.

Reverse transactions

Reverse transactions are operations whereby the ECB buys or sells assets under a repurchase agreement or conducts credit operations against collateral.

Under a repurchase agreement, securities are sold for cash with a simultaneous agreement to repurchase them from the counterparty at an agreed price on a set future date. Repurchase agreements are recorded as collateralised deposits on the liability side of the Balance Sheet. Securities sold under such an agreement remain on the Balance Sheet of the ECB.

Under a reverse repurchase agreement, securities are bought for cash with a simultaneous agreement to sell them back to the counterparty at an agreed price on a set future date. Reverse repurchase agreements are recorded as collateralised loans on the asset side of the Balance Sheet but are not included in the ECB's security holdings.

Reverse transactions (including security lending transactions) conducted under an automated security lending programme are recorded on the Balance Sheet only

3 A minimum threshold of €100,000 applies for administrative accruals and provisions.

where collateral is provided in the form of cash placed on an account of the ECB. In 2014 the ECB did not receive any collateral in the form of cash in connection with such transactions.

Off-balance-sheet instruments

Currency instruments, namely foreign exchange forward transactions, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date, are included in the net foreign currency position for the purpose of calculating foreign exchange gains and losses.

Interest rate instruments are revalued on an item-by-item basis. Daily changes in the variation margin of open interest rate futures contracts are recorded in the Profit and Loss Account. The valuation of forward transactions in securities and of interest rate swaps is based on generally accepted valuation methods using observable market prices and rates, as well as discount factors from the settlement dates to the valuation date.

Post-balance-sheet events

The values of assets and liabilities are adjusted for events that occur between the annual balance sheet date and the date on which the Executive Board authorises the submission of the ECB's Annual Accounts to the Governing Council for approval, if such events materially affect the condition of assets and liabilities at the balance sheet date.

Important post-balance-sheet events that do not affect the condition of assets and liabilities at the balance sheet date are disclosed in the notes.

Intra-ESCB balances/intra-Eurosystem balances

Intra-ESCB balances result primarily from cross-border payments in the EU that are settled in central bank money in euro. These transactions are for the most part initiated by private entities (i.e. credit institutions, corporations and individuals). They are settled in TARGET2 – the Trans-European Automated Real-time Gross settlement Express Transfer system – and give rise to bilateral balances in the TARGET2 accounts of EU central banks. These bilateral balances are netted out and then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB only. This position in the books of the ECB represents the net claim or liability of each NCB against the rest of the ESCB. Intra-Eurosystem balances of euro area NCBs vis-à-vis the ECB arising from TARGET2, as well as other intra-Eurosystem balances denominated in euro (e.g. interim profit distributions to NCBs), are presented on the Balance Sheet of the ECB as a single net asset or liability position and disclosed under "Other claims within the Eurosystem (net)" or "Other liabilities within the Eurosystem (net)". Intra-ESCB balances of non-euro area NCBs vis-à-vis the ECB, arising from their participation in TARGET2,[4] are disclosed under "Liabilities to non-euro area residents denominated in euro".

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are included as a single net asset under "Claims related to the allocation of euro banknotes within the Eurosystem" (see "Banknotes in circulation" in the notes on accounting policies).

Intra-Eurosystem balances arising from the transfer of foreign reserve assets to the ECB by NCBs joining the Eurosystem are denominated in euro and reported under "Liabilities equivalent to the transfer of foreign reserves".

Treatment of fixed assets

Fixed assets, including intangible assets, but with the exception of land and works of art, are valued at cost less depreciation. Land and works of art are valued at cost. For the depreciation of the ECB's new premises, costs are assigned to the appropriate asset components which will be depreciated in accordance with their estimated useful lives. Depreciation is calculated on a straight-line basis over the expected useful life of the assets, beginning in the quarter after the asset is available for use. The useful lives applied for the main asset classes are as follows:

Buildings	20, 25 or 50 years
Plant in building	10 or 15 years
Technical equipment	4, 10 or 15 years
Computers, related hardware and software, and motor vehicles	4 years
Furniture	10 years

The depreciation period for capitalised refurbishment expenditure relating to the ECB's existing rented premises is adjusted to take account of any events that have an impact on the expected useful life of the affected asset.

Fixed assets costing less than €10,000 are written off in the year of acquisition.

Fixed assets that comply with the capitalisation criteria but are still under construction or development are recorded under the heading "Assets under construction". The related costs are transferred to the relevant fixed asset headings once the assets are available for use.

4 As at 31 December 2014 the non-euro area NCBs participating in TARGET2 were Българска народна банка (Bulgarian National Bank), Danmarks Nationalbank, Lietuvos bankas, Narodowy Bank Polski and Banca Naţională a României.

The ECB's pension plans, other post-employment benefits and other long-term benefits

The ECB operates defined benefit plans for its staff and the members of the Executive Board, as well as for the members of the Supervisory Board employed by the ECB.

The staff pension plan is funded by assets held in a long-term employee benefit fund. The compulsory contributions made by the ECB and the staff are 19.5% and 6.7% of basic salary respectively and are reflected in the defined benefit pillar of the plan. Staff can make additional contributions on a voluntary basis in a defined contribution pillar that can be used to provide additional benefits.[5] These additional benefits are determined by the amount of voluntary contributions together with the investment returns arising from these contributions.

Unfunded arrangements are in place for the post-employment and other long-term benefits of members of the Executive Board and members of the Supervisory Board employed by the ECB. For staff, unfunded arrangements are in place for post-employment benefits other than pensions and for other long-term benefits.

Net defined benefit liability

The liability recognised in the Balance Sheet under "Other liabilities" in respect of the defined benefit plans is the present value of the defined benefit obligation at the balance sheet date, *less* the fair value of plan assets used to fund the obligation.

The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is calculated by discounting the estimated future cash flows using a rate which is determined by reference to market yields at the balance sheet date on high quality euro-denominated corporate bonds that have similar terms of maturity to the term of the pension obligation.

Actuarial gains and losses can arise from experience adjustments (where actual outcomes are different from the actuarial assumptions previously made) and changes in actuarial assumptions.

Net defined benefit cost

The net defined benefit cost is split into components reported in the Profit and Loss Account and remeasurements in respect of post-employment benefits shown in the Balance Sheet under "Revaluation accounts".

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5 The funds accumulated by a staff member through voluntary contributions can be used at retirement to purchase an additional pension. This pension is included in the defined benefit obligation from that point on.

The net amount charged to the Profit and Loss Account comprises:

(a) the current service cost of the defined benefits accruing for the year;

(b) net interest at the discount rate on the net defined benefit liability; and

(c) remeasurements in respect of other long-term benefits, in their entirety.

The net amount shown under “Revaluation accounts” comprises the following items:

(a) actuarial gains and losses on the defined benefit obligation;

(b) the actual return on plan assets, excluding amounts included in the net interest on the net defined benefit liability; and

(c) any change in the effect of the asset ceiling, excluding amounts included in the net interest on the net defined benefit liability.

These amounts are valued annually by independent actuaries to establish the appropriate liability in the financial statements.

Banknotes in circulation

The ECB and the euro area NCBs, which together comprise the Eurosystem, issue euro banknotes.[6] The total value of euro banknotes in circulation is allocated to the Eurosystem central banks on the last working day of each month in accordance with the banknote allocation key.[7]

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, which is disclosed in the Balance Sheet under the liability item “Banknotes in circulation”. The ECB’s share of the total euro banknote issue is backed by claims on the NCBs. These claims, which bear interest,[8] are disclosed under the sub-item “Intra-Eurosystem claims: claims related to the allocation of euro banknotes within the Eurosystem” (see “Intra-ESCB balances/intra-Eurosystem balances” in the notes on accounting policies). Interest income on these claims is included in the Profit and Loss Account under the item “Interest income arising from the allocation of euro banknotes within the Eurosystem”.

6 Decision ECB/2010/29 of 13 December 2010 on the issue of euro banknotes (recast), OJ L 35, 9.2.2011, p. 26, as amended.

7 “Banknote allocation key” means the percentages that result from taking into account the ECB’s share in the total euro banknote issue and applying the subscribed capital key to the NCBs’ share in that total.

8 Decision ECB/2010/23 of 25 November 2010 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (recast), OJ L 35, 9.2.2011, p. 17, as amended.

Interim profit distribution

The ECB's income on euro banknotes in circulation and income arising from the securities held for monetary policy purposes purchased under (a) the Securities Markets Programme; (b) the third covered bond purchase programme; and (c) the asset-backed securities purchase programme is due to the euro area NCBs in the financial year in which it accrues. Unless otherwise decided by the Governing Council, the ECB distributes this income in January of the following year by means of an interim profit distribution.[9] It is distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation and securities purchased under the aforementioned programmes, and subject to any decisions by the Governing Council to make transfers to the provision for foreign exchange rate, interest rate, credit and gold price risks. The Governing Council may also decide to charge costs incurred by the ECB in connection with the issue and handling of euro banknotes against income earned on euro banknotes in circulation.

Reclassifications

Fixed assets costing less than €10,000 were previously fully written off in the year of acquisition, and their cost was recorded under the heading "Depreciation of tangible and intangible fixed assets". Owing to the nature of this expense, the ECB decided in 2014 to include the related amounts under the heading "Administrative expenses". The comparable amounts for 2013 have been adjusted as follows:

	Published in 2013 €	Adjustment owing to reclassification €	Restated amount €
Depreciation of tangible and intangible fixed assets	(18,581,856)	8,113,170	(10,468,686)
Administrative expenses	(260,070,567)	(8,113,170)	(268,183,737)

This reclassification had no impact on the net profit reported for 2013.

Other issues

Taking account of the ECB's role as a central bank, the Executive Board considers that the publication of a cash-flow statement would not provide the readers of the financial statements with any additional relevant information.

In accordance with Article 27 of the Statute of the ESCB, and on the basis of a recommendation of the Governing Council, the EU Council has approved the appointment of Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft as the external auditors of the ECB for a five-year period up to the end of the financial year 2017.

9 Decision ECB/2014/57 of 15 December 2014 on the interim distribution of the income of the European Central Bank (recast), OJ L 53, 25.2.2015, p. 24.

Notes on the Balance Sheet

1 Gold and gold receivables

As at 31 December 2014 the ECB held 16,178,193 ounces[10] of fine gold (2013: 16,142,871 ounces). The increase was due to the transfer by Latvijas Banka to the ECB of 35,322 ounces of fine gold[11] upon the adoption of the single currency by Latvia. However, the increase in the euro equivalent value of the ECB's holdings of fine gold was mainly due to the rise in the price of gold during 2014 (see "Gold and foreign currency assets and liabilities" in the notes on accounting policies and note 15, "Revaluation accounts").

2 Claims on non-euro area and euro area residents denominated in foreign currency

2.1 Receivables from the IMF

This asset represents the ECB's holdings of SDRs as at 31 December 2014. It arises as the result of a two-way SDR buying and selling arrangement with the International Monetary Fund (IMF), whereby the IMF is authorised to arrange sales or purchases of SDRs against euro, on behalf of the ECB, within minimum and maximum holding levels. For accounting purposes, SDRs are treated as a foreign currency (see "Gold and foreign currency assets and liabilities" in the notes on accounting policies). The increase in the euro equivalent value of the ECB's holdings of SDRs was mainly due to the appreciation of the SDR against the euro during 2014.

2.2 Balances with banks and security investments, external loans and other external assets; and claims on euro area residents denominated in foreign currency

These two items consist of balances with banks and loans denominated in foreign currency, and investments in securities denominated in US dollars and Japanese yen.

Claims on non-euro area residents	2014 €	2013 €	Change €
Current accounts	2,618,332,591	939,722,501	1,678,610,090
Money market deposits	1,035,952,558	1,001,428,468	34,524,090
Reverse repurchase agreements	986,131,163	87,738,380	898,392,783
Security investments	39,090,487,693	36,735,365,690	2,355,122,003
Total	**43,730,904,005**	**38,764,255,039**	**4,966,648,966**

[10] This corresponds to 503.2 tonnes.

[11] The transfer, with a value equivalent to €30.8 million, was made with effect from 1 January 2014.

Claims on euro area residents	2014 €	2013 €	Change €
Current accounts	4,035,172	4,242,115	(206,943)
Money market deposits	1,599,827,033	1,266,550,649	333,276,384
Reverse repurchase agreements	179,865,744	0	179,865,744
Total	**1,783,727,949**	**1,270,792,764**	**512,935,185**

The increase in these items in 2014 was mainly due to the appreciation of the US dollar against the euro.

Additionally, upon the adoption of the single currency by Latvia with effect from 1 January 2014, Latvijas Banka transferred foreign reserve assets denominated in Japanese yen with a value of €174.5 million to the ECB.

The ECB's net foreign currency holdings of US dollars and Japanese yen,[12] as at 31 December 2014, were as follows:

	2014 Currency in millions	2013 Currency in millions
US dollars	45,649	45,351
Japanese yen	1,080,094	1,051,062

3 Claims on non-euro area residents denominated in euro

3.1 Balances with banks, security investments and loans

As at 31 December 2013, this item consisted of a claim on a non-euro area central bank in connection with an agreement on repurchase transactions established with the ECB. Under this agreement the non-euro area central bank could borrow euro against eligible collateral in order to support its domestic liquidity-providing operations.

No related claims remained outstanding as at 31 December 2014.

4 Other claims on euro area credit institutions denominated in euro

As at 31 December 2014 this item consisted of current accounts with euro area residents.

[12] These holdings comprise assets minus liabilities denominated in the given foreign currency that are subject to foreign currency revaluation. They are included under the headings "Claims on non-euro area residents denominated in foreign currency", "Claims on euro area residents denominated in foreign currency", "Accruals and prepaid expenses", "Liabilities to non-euro area residents denominated in foreign currency", "Off-balance-sheet instruments revaluation differences" (liabilities side) and "Accruals and income collected in advance" and take into account foreign exchange forward and swap transactions included in off-balance-sheet items. Price gains on financial instruments denominated in foreign currency arising as a result of revaluations are not included.

5 Securities of euro area residents denominated in euro

5.1 Securities held for monetary policy purposes

As at 31 December 2014 this item consisted of securities acquired by the ECB within the scope of the three covered bond purchase programmes, the Securities Markets Programme and the asset-backed securities purchase programme.

Purchases under the first covered bond purchase programme were completed on 30 June 2010, while the second covered bond purchase programme ended on 31 October 2012. The Securities Markets Programme was terminated on 6 September 2012.

On 2 October 2014 the Governing Council announced the operational details of the third covered bond purchase programme and the asset-backed securities purchase programme. These programmes, which will last for at least two years, will facilitate credit provision to the euro area economy, generate positive spillovers to other markets and, as a result, ease the ECB’s monetary policy stance. Under the two programmes, the ECB and the NCBs may purchase, in both the primary and secondary markets, euro-denominated covered bonds issued in the euro area and senior and guaranteed mezzanine tranches of asset-backed securities that are denominated in euro and issued by entities that are resident in the euro area.

Securities purchased under all five programmes are valued on an amortised cost basis subject to impairment (see “Securities” in the notes on accounting policies). Annual impairment tests are conducted on the basis of the estimated recoverable amounts as at the year-end. The Governing Council considered that the identified impairment indicators had not affected the estimated future cash flows expected to be received by the ECB. Consequently, no losses were recorded for these securities in 2014.

The amortised cost of these securities, as well as their market value[13] (which is not recorded on the Balance Sheet or in the Profit and Loss Account but is provided for comparison purposes only), are as follows:

	2014 €		2013 €		Change €	
	Amortised cost	Market value	Amortised cost	Market value	Amortised cost	Market value
First covered bond purchase programme	2,395,178,568	2,576,479,183	3,710,724,329	3,880,523,066	(1,315,545,761)	(1,304,043,883)
Second covered bond purchase programme	1,249,397,951	1,367,880,767	1,459,074,444	1,559,027,391	(209,676,493)	(191,146,624)
Third covered bond purchase programme	2,298,798,185	2,314,787,199	-	-	2,298,798,185	2,314,787,199
Securities Markets Programme	10,100,343,269	11,247,795,991	12,990,138,931	13,689,860,491	(2,889,795,662)	(2,442,064,500)
Asset-backed securities purchase programme	1,744,230,394	1,742,441,349	-	-	1,744,230,394	1,742,441,349
Total	**17,787,948,367**	**19,249,384,489**	**18,159,937,704**	**19,129,410,948**	**(371,989,337)**	**119,973,541**

13 Market values are indicative and were derived on the basis of market quotes. When market quotes were not available, market prices were estimated using internal Eurosystem models.

The decrease in the amortised cost of the portfolios held under (a) the first and second covered bond purchase programmes, and (b) the Securities Markets Programme was due to redemptions.

The Governing Council assesses on a regular basis the financial risks associated with the securities held under the Securities Markets Programme, the asset-backed securities purchase programme and the three covered bond purchase programmes.

6 Intra-Eurosystem claims

6.1 Claims related to the allocation of euro banknotes within the Eurosystem

This item consists of the claims of the ECB vis-à-vis the euro area NCBs relating to the allocation of euro banknotes within the Eurosystem (see “Banknotes in circulation” in the notes on accounting policies). The remuneration of these claims is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations (see note 24.2, “Interest income arising from the allocation of euro banknotes within the Eurosystem”).

7 Other assets

7.1 Tangible and intangible fixed assets

These assets comprised the following items on 31 December 2014:

	2014 €	2013 €	Change €
Cost			
Land and buildings	997,154,850	170,824,151	826,330,699
Plant in building	212,838,181	72,341	212,765,840
Computer hardware and software	71,812,322	76,353,659	(4,541,337)
Equipment, furniture and motor vehicles	82,854,876	13,746,611	69,108,265
Assets under construction	16,163,065	847,217,209	(831,054,144)
Other fixed assets	8,241,408	7,751,953	489,455
Total cost	**1,389,064,702**	**1,115,965,924**	**273,098,778**
Accumulated depreciation			
Land and buildings	(88,477,513)	(86,542,592)	(1,934,921)
Plant in building	(72,342)	(72,341)	(1)
Computer hardware and software	(38,380,961)	(45,004,046)	6,623,085
Equipment, furniture and motor vehicles	(11,908,686)	(12,797,447)	888,761
Other fixed assets	(628,541)	(373,708)	(254,833)
Total accumulated depreciation	**(139,468,043)**	**(144,790,134)**	**5,322,091**
Net book value	**1,249,596,659**	**971,175,790**	**278,420,869**

The ECB’s new premises became available for use in November 2014 and the related costs were therefore transferred from the item “Assets under construction” to the appropriate headings. The increase in the cost of the “Land and buildings”, “Plant in building” and “Equipment, furniture and motor vehicles” categories mainly reflects this transfer, as well as activities in the last two months of 2014 related to the ECB’s new premises.

Moreover, the contribution from the City of Frankfurt of €15.3 million for the preservation of the Grossmarkthalle, which in previous years was disclosed under “Accruals and income collected in advance”, was netted against the cost of the new building.

7.2 Other financial assets

This item consists of the investment of the ECB’s own funds[14] held as a direct counterpart to the capital and reserves of the ECB, as well as other financial assets which include 3,211 shares in the Bank for International Settlements (BIS) at the acquisition cost of €41.8 million.

The components of this item are as follows:

	2014 €	2013 €	Change €
Current accounts in euro	4,684,410	4,620,701	63,709
Securities denominated in euro	19,091,635,302	18,068,315,142	1,023,320,160
Reverse repurchase agreements in euro	1,488,138,078	2,351,403,533	(863,265,455)
Other financial assets	41,902,068	41,906,524	(4,456)
Total	**20,626,359,858**	**20,466,245,900**	**160,113,958**

The net increase in this item in 2014 was due mainly to (a) the reinvestment of interest income generated on the own funds portfolio; and (b) the increase in the market value of the securities denominated in euro.

7.3 Off-balance-sheet instruments revaluation differences

This item is composed mainly of valuation changes in swap and forward transactions in foreign currency that were outstanding on 31 December 2014 (see note 22, “Foreign exchange swap and forward transactions”). These valuation changes are the result of the conversion of such transactions into their euro equivalents at the exchange rates prevailing on the balance sheet date, compared with the euro values resulting from the conversion of the transactions at the average cost of the respective foreign currency on that date (see “Off-balance-sheet instruments” and “Gold and foreign currency assets and liabilities” in the notes on accounting policies).

Valuation gains on outstanding interest rate swap transactions are also included in this item (see note 20, “Interest rate swaps”).

[14] Repurchase agreements conducted in the context of the management of the own funds portfolio are reported under “Sundry” on the liabilities side (see note 13.3, “Sundry”).

7.4 Accruals and prepaid expenses

In 2014 this item included accrued coupon interest on securities, including outstanding interest paid at acquisition, amounting to €603.9 million (2013: €708.3 million) (see note 2.2, “Balances with banks and security investments, external loans and other external assets; and Claims on euro area residents denominated in foreign currency”, note 5, “Securities of euro area residents denominated in euro”, and note 7.2, “Other financial assets”).

It also included accrued interest receivable on the TARGET2 balances due from euro area NCBs for December 2014, amounting to €25.5 million (2013: €155.1 million), and accrued interest receivable on the ECB’s claims related to the allocation of euro banknotes within the Eurosystem for the final quarter of the year (see “Banknotes in circulation” in the notes on accounting policies), amounting to €10.0 million (2013: €69.2 million).

This item also includes (a) accrued income from common Eurosystem projects (see note 30, “Other income”); (b) accrued income in connection with the Single Supervisory Mechanism (see note 28, “Income and expenses related to supervisory tasks”); (c) accrued interest income on other financial assets; and (d) miscellaneous prepayments.

7.5 Sundry

This item consisted mainly of the accrued amounts of the ECB’s interim profit distribution (see “Interim profit distribution” in the notes on accounting policies and note 12.2, “Other liabilities within the Eurosystem (net)”).

It also included:

(a) balances related to swap and forward transactions in foreign currency outstanding on 31 December 2014 that arose from the conversion of such transactions into their euro equivalents at the respective currency’s average cost on the balance sheet date, compared with the euro values at which the transactions were initially recorded (see “Off-balance-sheet instruments” in the notes on accounting policies).

(b) a claim against the German Federal Ministry of Finance in respect of recoverable value added tax and other indirect taxes paid. Such taxes are refundable under the terms of Article 3 of the Protocol on the privileges and immunities of the European Union, which applies to the ECB by virtue of Article 39 of the Statute of the ESCB.

8 Banknotes in circulation

This item consists of the ECB’s share (8%) of the total euro banknotes in circulation (see “Banknotes in circulation” in the notes on accounting policies).

9 Liabilities to other euro area residents denominated in euro

9.1 Other liabilities

This item comprises deposits by members of the Euro Banking Association (EBA) which are used in order to provide the ECB with collateral in respect of the EBA's payments settled through the TARGET2 system.

10 Liabilities to non-euro area residents denominated in euro

As at 31 December 2014 this item comprised an amount of €0.9 billion (2013: €24.6 billion), consisting of balances held with the ECB by non-euro area NCBs and other central banks that arise from, or are the counterpart of, transactions processed via the TARGET2 system. The decrease in these balances in 2014 was due to payments from non-euro area residents to euro area residents and resulted in an increase in the TARGET2 balances of the euro area NCBs vis-à-vis the ECB (see note 12.2, "Other liabilities within the Eurosystem (net)").

In 2013 this item also included an amount of €0.2 billion arising from the temporary reciprocal currency arrangement with the Federal Reserve. Under this arrangement, US dollars are provided by the Federal Reserve to the ECB by means of swap transactions, with the aim of offering short-term US dollar funding to Eurosystem counterparties. The ECB simultaneously enters into back-to-back swap transactions with euro area NCBs, which use the resulting funds to conduct US dollar liquidity-providing operations with Eurosystem counterparties in the form of reverse transactions. The back-to-back swap transactions result in intra-Eurosystem balances between the ECB and the NCBs. In 2014 the Governing Council decided, in view of the considerable improvement in US dollar funding conditions and the low demand for US dollar liquidity-providing operations, to gradually reduce its offering of such operations. No related balances remained outstanding as at 31 December 2014. In the future the ECB will, on a regular basis, assess the need for such operations, taking into account the fact that the established standing swap lines have created a framework for the provision of US dollar liquidity to counterparties, if warranted by market conditions.

11 Liabilities to non-euro area residents denominated in foreign currency

11.1 Deposits, balances and other liabilities

This item consists of liabilities that arose under repurchase agreements conducted with non-euro area residents in connection with the management of the foreign currency reserves of the ECB.

12 Intra-Eurosystem liabilities

12.1 Liabilities equivalent to the transfer of foreign reserves

These represent the liabilities to the euro area NCBs that arose from the transfer of foreign reserve assets to the ECB when they joined the Eurosystem.

The adjustment of the NCBs' weightings in the ECB's capital key (see note 16, "Capital and reserves"), together with Latvijas Banka's transfer of foreign reserve assets upon Latvia's adoption of the single currency, led to an increase of €243,510,283 in these liabilities.

	Since 1 January 2014 €	As at 31 December 2013 €
Nationale Bank van België/Banque Nationale de Belgique	1,435,910,943	1,401,024,415
Deutsche Bundesbank	10,429,623,058	10,871,789,515
Eesti Pank	111,729,611	103,152,857
Central Bank of Ireland	672,637,756	643,894,039
Bank of Greece	1,178,260,606	1,129,060,170
Banco de España	5,123,393,758	4,782,873,430
Banque de France	8,216,994,286	8,190,916,316
Banca d'Italia	7,134,236,999	7,218,961,424
Central Bank of Cyprus	87,679,928	77,248,740
Latvijas Banka	163,479,892	-
Banque centrale du Luxembourg	117,640,617	100,776,864
Central Bank of Malta	37,552,276	36,798,912
De Nederlandsche Bank	2,320,070,006	2,298,512,218
Oesterreichische Nationalbank	1,137,636,925	1,122,511,702
Banco de Portugal	1,010,318,483	1,022,024,594
Banka Slovenije	200,220,853	189,499,911
Národná banka Slovenska	447,671,807	398,761,127
Suomen Pankki – Finlands Bank	728,096,904	721,838,191
Total	**40,553,154,708**	**40,309,644,425**

Latvijas Banka's claim was set at €163,479,892 in order to ensure that the ratio between this claim and the aggregate claim credited to the other NCBs of Member States whose currency is the euro will be equal to the ratio between Latvijas Banka's weighting in the ECB's capital key and the other euro area NCBs' aggregate weighting in this key. The difference between the claim and the value of the assets transferred (see note 1, "Gold and gold receivables", and note 2.2, "Balances with banks and security investments, external loans and other external assets; and Claims on euro area residents denominated in foreign currency") was treated as part of the contributions of Latvijas Banka, due under Article 48.2 of the Statute of the ESCB, to the reserves and provisions equivalent to reserves of the ECB existing as at 31 December 2013 (see note 14, "Provisions", and note 15, "Revaluation accounts").

The remuneration of these liabilities is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations, adjusted to reflect a zero return on the gold component (see note 24.3, "Remuneration of NCBs' claims in respect of foreign reserves transferred").

12.2 Other liabilities within the Eurosystem (net)

In 2014 this item consisted mainly of the TARGET2 balances of the euro area NCBs vis-à-vis the ECB (see "Intra-ESCB balances/intra-Eurosystem balances" in the notes on accounting policies). The net increase in this position resulted mainly from the settlement in TARGET2 of payments from non-euro area residents to euro area residents (see note 10, "Liabilities to non-euro area residents denominated in euro"). The reduction in the amounts related to back-to-back swap transactions conducted with NCBs in connection with US dollar liquidity-providing operations also contributed to the increase in the net liability in 2014. The impact of these two factors was partially offset by redemptions of securities purchased under the Securities Markets Programme and the first two covered bond purchase programmes that were settled via TARGET2 accounts.

The remuneration of TARGET2 positions, with the exception of balances arising from back-to-back swap transactions in connection with US dollar liquidity-providing operations, is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations.

This item also included the amount due to euro area NCBs in respect of the ECB's interim profit distribution (see "Interim profit distribution" in the notes on accounting policies).

	2014 €	2013 €
Due from euro area NCBs in respect of TARGET2	(590,153,944,468)	(687,997,098,717)
Due to euro area NCBs in respect of TARGET2	612,892,597,646	686,747,265,644
Due to euro area NCBs in respect of the ECB's interim profit distribution	840,719,787	1,369,690,567
Other liabilities within the Eurosystem (net)	**23,579,372,965**	**119,857,494**

13 Other liabilities

13.1 Off-balance-sheet instruments revaluation differences

This item is composed mainly of valuation changes in swap and forward transactions in foreign currency that were outstanding on 31 December 2014 (see note 22, "Foreign exchange swap and forward transactions"). These valuation changes are the result of the conversion of such transactions into their euro equivalents at the exchange rates prevailing on the balance sheet date, compared with the euro values resulting from the conversion of the transactions at the average cost of the respective foreign currency on that date (see "Off-balance-sheet instruments" and "Gold and foreign currency assets and liabilities" in the notes on accounting policies).

Valuation losses on outstanding interest rate swaps are also included in this item (see note 20, "Interest rate swaps").

13.2 Accruals and income collected in advance

As at 31 December 2014 the two main items under this heading were accrued interest payable to the NCBs for the whole of 2014 in respect of their claims relating to foreign reserves transferred to the ECB (see note 12.1, "Liabilities equivalent to the transfer of foreign reserves") and accrued interest payable on TARGET2 balances due to NCBs for the final month of 2014. These amounts were settled in January 2015. Other accruals, including accruals on financial instruments, are also reported in this item.

	2014 €	2013 €	Change €
Foreign reserves transferred to the ECB	57,015,146	192,248,631	(135,233,485)
TARGET2	26,309,091	155,757,290	(129,448,199)
Other accruals	12,867,414	22,536,286	(9,668,872)
Total	**96,191,651**	**370,542,207**	**(274,350,556)**

13.3 Sundry

In 2014 this item included outstanding repurchase transactions of €150.1 million (2013: €480.4 million) conducted in connection with the management of the ECB's own funds (see note 7.2, "Other financial assets").

It also included balances related to swap and forward transactions in foreign currency that were outstanding on 31 December 2014 (see note 22, "Foreign exchange swap and forward transactions"). These balances arose from the conversion of such transactions into their euro equivalents at the respective currency's average cost on the balance sheet date, compared with the euro values at which the transactions were initially recorded (see "Off-balance-sheet instruments" in the notes on accounting policies).

The ECB's pension plans, other post-employment benefits and other long-term benefits[15]

In addition, this item included the ECB's net defined benefit liability in respect of the post-employment and other long-term benefits of its staff and the members of the Executive Board, as well as the members of the Supervisory Board employed by the ECB, amounting to €459.7 million (2013: €131.9 million).

Balance Sheet

The amounts recognised in the Balance Sheet in respect of post-employment and other long-term employee benefits were as follows:

[15] In all tables of this note, the column labelled "Boards" reports the amounts in respect of both the Executive Board and the Supervisory Board from 2014 onwards.

	2014 Staff	2014 Boards	2014 Total	2013 Staff	2013 Boards	2013 Total
	€ millions	€ millions	€ millions	€ millions	€ millions	€ millions
Present value of obligation	1,087.1	24.5	1,111.6	650.6	17.8	668.4
Fair value of plan assets	(651.9)	-	(651.9)	(536.5)	-	(536.5)
Net defined benefit liability recognised in the Balance Sheet	**435.2**	**24.5**	**459.7**	**114.1**	**17.8**	**131.9**

In 2014 the present value of the obligation vis-à-vis staff of €1,087.1 million (2013: €650.6 million) included unfunded benefits amounting to €170.3 million (2013: €109.4 million) relating to post-employment benefits other than pensions and to other long-term benefits. Unfunded arrangements are also in place for the post-employment and other long-term benefits of members of the Executive Board and members of the Supervisory Board.

Profit and Loss Account

The amounts recognised in the Profit and Loss Account in 2014 were as follows:

	2014 Staff	2014 Boards	2014 Total	2013 Staff	2013 Boards	2013 Total
	€ millions	€ millions	€ millions	€ millions	€ millions	€ millions
Current service cost	41.7	1.2	42.9	45.9	1.4	47.3
Net interest on the net defined benefit liability	4.5	0.7	5.2	8.6	0.6	9.2
of which:						
Cost on the obligation	*25.1*	*0.7*	*25.8*	*24.4*	*0.6*	*25.0*
Income on plan assets	*(20.6)*	*-*	*(20.6)*	*(15.8)*	*-*	*(15.8)*
Remeasurement (gains)/losses on other long-term benefits	7.8	0.3	8.1	(3.2)	0	(3.2)
Total included in "Staff costs"	**54.0**	**2.2**	**56.2**	**51.3**	**2.0**	**53.3**

Changes in the defined benefit obligation, plan assets and remeasurement results

Changes in the present value of the defined benefit obligation were as follows:

	2014 Staff	2014 Boards	2014 Total	2013 Staff	2013 Boards	2013 Total
	€ millions	€ millions	€ millions	€ millions	€ millions	€ millions
Opening defined benefit obligation	650.6	17.8	668.4	677.8	17.8	695.6
Current service cost	41.7	1.2	42.9	45.9	1.4	47.3
Interest cost on the obligation	25.1	0.7	25.8	24.4	0.6	25.0
Contributions paid by plan participants	14.0	0.1	14.1	12.3	0.1	12.4
Benefits paid	(7.1)	(0.8)	(7.9)	(5.5)	(1.1)	(6.6)
Remeasurement (gains)/losses	362.8	5.5	368.3	(104.3)	(1.0)	(105.3)
Closing defined benefit obligation	**1,087.1**	**24.5**	**1,111.6**	**650.6**	**17.8**	**668.4**

The total remeasurement losses of €368.3 million for 2014 on the defined benefit obligation arose primarily owing to the decrease in the discount rate from 3.75% in 2013 to 2.0% in 2014. This compares with remeasurement gains of €105.3 million for

2013 which arose primarily owing to the lower conversion factors applied for the calculation of future pension payments, as well as the increase in the discount rate from 3.5% in 2012 to 3.75% in 2013.

Changes in 2014 in the fair value of plan assets in the defined benefit pillar relating to staff were as follows:

	2014 € millions	2013 € millions
Opening fair value of plan assets	536.5	439.3
Interest income on plan assets	20.6	15.8
Remeasurement gains	49.7	39.8
Contributions paid by employer	36.4	33.2
Contributions paid by plan participants	14.0	12.3
Benefits paid	(5.3)	(3.9)
Closing fair value of plan assets	**651.9**	**536.5**

Remeasurement gains on plan assets in both 2014 and 2013 reflected the fact that actual returns on the fund units were higher than the estimated interest income on plan assets.

In 2014, following a funding valuation of the ECB's staff pension plan carried out by the ECB's actuaries as at 31 December 2013, the Governing Council decided to reduce from €10.3 million to €6.8 million the annual supplementary contributions payable up to 2023. This decision will be reviewed upon receipt of the next funding valuation, which is planned for 2015. This reduction was more than offset by (a) the increase in the contributions made by the ECB to the staff pension plan (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies); and (b) the increase in the number of plan members in the context of the preparations for the launch of the Single Supervisory Mechanism (see note 31, "Staff costs"). Consequently, the values reported under the item "Contributions paid by employer" increased to €36.4 million (2013: €33.2 million).

Changes in 2014 in the remeasurement results (see note 15, "Revaluation accounts") were as follows:

	2014 € millions[16]	2013 € millions
Opening remeasurement gains/(losses)	4.8	(137.1)
Gains on plan assets	49.7	39.8
Gains/(losses) on obligation	(368.3)	105.3
Losses/(gains) recognised in the Profit and Loss Account	8.1	(3.2)
Closing remeasurement gains/(losses) included under "Revaluation accounts"	**(305.6)**	**4.8**

16 Totals may not add up due to rounding.

Key assumptions

In preparing the valuations referred to in this note, the actuaries have used assumptions which the Executive Board has accepted for the purposes of accounting and disclosure. The principal assumptions used for the purposes of calculating the benefits scheme liability are as follows:

	2014 %	2013 %
Discount rate	2.00	3.75
Expected return on plan assets[17]	3.00	4.75
General future salary increases[18]	2.00	2.00
Future pension increases[19]	1.40	1.40

Furthermore, voluntary contributions made by staff in a defined contribution pillar in 2014 amounted to €110.6 million (2013: €96.5 million). These assets are invested in plan assets but also give rise to a corresponding obligation of equal value.

14 Provisions

This item consists mainly of a provision for foreign exchange rate, interest rate, credit and gold price risks.

The provision for foreign exchange rate, interest rate, credit and gold price risks will be used to the extent deemed necessary by the Governing Council to offset future realised and unrealised losses, in particular valuation losses not covered by the revaluation accounts. The size of and continuing requirement for this provision is reviewed annually, based on the ECB's assessment of its exposure to these risks. This assessment takes a range of factors into account, including in particular the level of holdings of risk-bearing assets, the extent of materialised risk exposures in the current financial year, projected results for the coming year, and a risk assessment involving calculations of Values at Risk (VaR) on risk-bearing assets, which is applied consistently over time. The provision, together with any amount held in the general reserve fund, may not exceed the value of the ECB's capital paid up by the euro area NCBs.

As at 31 December 2013 the provision for foreign exchange rate, interest rate, credit and gold price risks amounted to €7,529,669,242. In addition, Latvijas Banka contributed an amount of €30,476,837 with effect from 1 January 2014.[20] Taking the results of its assessment into account, the Governing Council decided to transfer, as

17 These assumptions were used for calculating the part of the ECB's defined benefit obligation which is funded by assets with an underlying capital guarantee.

18 In addition, allowance is made for prospective individual salary increases of up to 1.8% per annum, depending on the age of the plan participants.

19 According to the ECB's pension plan rules, pensions will be increased annually. If general salary adjustments for ECB employees were below price inflation, any increase in pensions will be in line with the general salary adjustments. If the general salary adjustments exceed price inflation, they will be applied to determine the increase in pensions, provided that the financial position of the ECB's pension plans permits such an increase.

20 In accordance with Article 48.2 of the Statute of the ESCB.

at 31 December 2014, an amount of €15,009,843 to the provision. This transfer reduced the ECB's net profit for 2014 to €988,832,500 and increased the size of the provision to €7,575,155,922. Following the increase in the ECB's paid-up capital in 2014 (see note 16, "Capital and reserves"), this amount corresponds to the value of the ECB's capital paid up by the euro area NCBs as at 31 December 2014.

15 Revaluation accounts

This item consists mainly of revaluation balances arising from unrealised gains on assets, liabilities and off-balance-sheet instruments (see "Income recognition", "Gold and foreign currency assets and liabilities", "Securities" and "Off-balance-sheet instruments" in the notes on accounting policies). It also includes the remeasurements of the ECB's net defined benefit liability in respect of post-employment benefits (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies and note 13.3, "Sundry").

Upon the adoption of the single currency by Latvia, Latvijas Banka contributed an amount of €54.1 million to these balances with effect from 1 January 2014.

	2014 €	2013 €	Change €
Gold	12,065,394,836	10,138,805,097	1,926,589,739
Foreign currency	7,046,435,041	2,540,202,558	4,506,232,483
Securities and other instruments	1,131,424,399	674,356,531	457,067,868
Net defined benefit liability in respect of post-employment benefits	(305,609,580)	4,825,887	(310,435,467)
Total	**19,937,644,696**	**13,358,190,073**	**6,579,454,623**

The increase in the size of the revaluation accounts is predominately due to the depreciation of the euro against the US dollar and gold in 2014.

The foreign exchange rates used for the year-end revaluation were as follows:

Exchange rates	2014	2013
US dollars per euro	1.2141	1.3791
Japanese yen per euro	145.23	144.72
Euro per SDR	1.1924	1.1183
Euro per fine ounce of gold	987.769	871.220

16 Capital and reserves

16.1 Capital

(A) Change to the ECB's capital key

Pursuant to Article 29 of the Statute of the ESCB, the shares of the NCBs in the ECB's capital key are weighted according to the shares of the respective Member States in the EU's total population and GDP in equal measure, as notified to the ECB by the European Commission. These weights are adjusted every five years and whenever new Member States join the EU. The third such adjustment following the establishment of the ECB was made on 1 January 2014.

Based on Council Decision 2003/517/EC of 15 July 2003 on the statistical data to be used for the adjustment of the key for subscription to the capital of the European Central Bank,[21] the NCBs' capital key shares were adjusted on 1 January 2014 as follows:

	Capital key since 1 January 2014 %	Capital key as at 31 December 2013 %
Nationale Bank van België/Banque Nationale de Belgique	2.4778	2.4176
Deutsche Bundesbank	17.9973	18.7603
Eesti Pank	0.1928	0.1780
Central Bank of Ireland	1.1607	1.1111
Bank of Greece	2.0332	1.9483
Banco de España	8.8409	8.2533
Banque de France	14.1792	14.1342
Banca d'Italia	12.3108	12.4570
Central Bank of Cyprus	0.1513	0.1333
Latvijas Banka	0.2821	-
Banque centrale du Luxembourg	0.2030	0.1739
Central Bank of Malta	0.0648	0.0635
De Nederlandsche Bank	4.0035	3.9663
Oesterreichische Nationalbank	1.9631	1.9370
Banco de Portugal	1.7434	1.7636
Banka Slovenije	0.3455	0.3270
Národná banka Slovenska	0.7725	0.6881
Suomen Pankki – Finlands Bank	1.2564	1.2456
Subtotal for euro area NCBs	**69.9783**	**69.5581**
Българска народна банка (Bulgarian National Bank)	0.8590	0.8644
Česká národní banka	1.6075	1.4539
Danmarks Nationalbank	1.4873	1.4754
Hrvatska narodna banka	0.6023	0.5945
Latvijas Banka	-	0.2742
Lietuvos bankas	0.4132	0.4093
Magyar Nemzeti Bank	1.3798	1.3740
Narodowy Bank Polski	5.1230	4.8581
Banca Naţională a României	2.6024	2.4449
Sveriges Riksbank	2.2729	2.2612
Bank of England	13.6743	14.4320
Subtotal for non-euro area NCBs	**30.0217**	**30.4419**
Total	**100.0000**	**100.0000**

(B) Capital of the ECB[22]

Latvia adopted the single currency on 1 January 2014. In accordance with Article 48.1 of the Statute of the ESCB, Latvijas Banka paid up an amount of €29,424,264 as at 1 January 2014, representing the remainder of its capital subscription to the ECB. The adjustment of the NCBs' capital key shares in conjunction with Latvia

[21] OJ L 181, 19.7.2003, p. 43.

[22] Individual amounts are shown rounded to the nearest euro. Consequently, totals and subtotals in the table may not add up due to rounding.

joining the euro area led to an increase of €43,780,929 in the paid-up capital of the ECB, which rose to €7,697,025,340.

The non-euro area NCBs are required to pay up 3.75% of their subscribed capital as a contribution to the operational costs of the ECB. This contribution amounted to a total of €121,869,418 at the end of 2014. The non-euro area NCBs are not entitled to receive any share of the distributable profits of the ECB, including income arising from the allocation of euro banknotes within the Eurosystem, nor are they liable to fund any loss of the ECB.

	Subscribed capital since 1 January 2014 €	Paid-up capital since 1 January 2014 €	Subscribed capital as at 31 December 2013 €	Paid-up capital as at 31 December 2013 €
Nationale Bank van België/ Banque Nationale de Belgique	268,222,025	268,222,025	261,705,371	261,705,371
Deutsche Bundesbank	1,948,208,997	1,948,208,997	2,030,803,801	2,030,803,801
Eesti Pank	20,870,614	20,870,614	19,268,513	19,268,513
Central Bank of Ireland	125,645,857	125,645,857	120,276,654	120,276,654
Bank of Greece	220,094,044	220,094,044	210,903,613	210,903,613
Banco de España	957,028,050	957,028,050	893,420,308	893,420,308
Banque de France	1,534,899,402	1,534,899,402	1,530,028,149	1,530,028,149
Banca d'Italia	1,332,644,970	1,332,644,970	1,348,471,131	1,348,471,131
Central Bank of Cyprus	16,378,236	16,378,236	14,429,734	14,429,734
Latvijas Banka	30,537,345	30,537,345	-	-
Banque centrale du Luxembourg	21,974,764	21,974,764	18,824,687	18,824,687
Central Bank of Malta	7,014,605	7,014,605	6,873,879	6,873,879
De Nederlandsche Bank	433,379,158	433,379,158	429,352,255	429,352,255
Oesterreichische Nationalbank	212,505,714	212,505,714	209,680,387	209,680,387
Banco de Portugal	188,723,173	188,723,173	190,909,825	190,909,825
Banka Slovenije	37,400,399	37,400,399	35,397,773	35,397,773
Národná banka Slovenska	83,623,180	83,623,180	74,486,874	74,486,874
Suomen Pankki – Finlands Bank	136,005,389	136,005,389	134,836,288	134,836,288
Subtotal for euro area NCBs	**7,575,155,922**	**7,575,155,922**	**7,529,669,242**	**7,529,669,242**
Българска народна банка (Bulgarian National Bank)	92,986,811	3,487,005	93,571,361	3,508,926
Česká národní banka	174,011,989	6,525,450	157,384,778	5,901,929
Danmarks Nationalbank	161,000,330	6,037,512	159,712,154	5,989,206
Hrvatska narodna banka	65,199,018	2,444,963	64,354,667	2,413,300
Latvijas Banka	-	-	29,682,169	1,113,081
Lietuvos bankas	44,728,929	1,677,335	44,306,754	1,661,503
Magyar Nemzeti Bank	149,363,448	5,601,129	148,735,597	5,577,585
Narodowy Bank Polski	554,565,112	20,796,192	525,889,668	19,720,863
Banca Naţională a României	281,709,984	10,564,124	264,660,598	9,924,772
Sveriges Riksbank	246,041,586	9,226,559	244,775,060	9,179,065
Bank of England	1,480,243,942	55,509,148	1,562,265,020	58,584,938
Subtotal for non-euro area NCBs	**3,249,851,147**	**121,869,418**	**3,295,337,827**	**123,575,169**
Total	**10,825,007,070**	**7,697,025,340**	**10,825,007,070**	**7,653,244,411**

17 Post-balance-sheet events

17.1 Entry of Lithuania into the euro area

Pursuant to Council Decision 2014/509/EU of 23 July 2014, taken in accordance with Article 140(2) of the Treaty on the Functioning of the European Union, Lithuania adopted the single currency on 1 January 2015. In accordance with Article 48.1 of the Statute of the ESCB and the legal acts adopted by the Governing Council on 31 December 2014,[23] Lietuvos bankas paid up an amount of €43,051,594 as at 1 January 2015, representing the remainder of its capital subscription to the ECB. In accordance with Article 48.1, in conjunction with Article 30.1, of the Statute of the ESCB, Lietuvos bankas transferred foreign reserve assets with a total value equivalent to €338,656,542 to the ECB with effect from 1 January 2015. These foreign reserve assets comprised amounts of US dollars in the form of cash, and gold, in proportions of 85 to 15 respectively.

Lietuvos bankas was credited with claims in respect of the paid-up capital and foreign reserve assets equivalent to the amounts transferred. The latter is to be treated in an identical manner to the existing claims of the other euro area NCBs (see note 12.1, "Liabilities equivalent to the transfer of foreign reserves").

Off-balance-sheet instruments

18 Automated security lending programme

As part of the management of the ECB's own funds, the ECB has an automated security lending programme agreement in place, whereby an appointed agent enters into security lending transactions on behalf of the ECB with a number of designated eligible counterparties. Under this agreement, reverse transactions with a value of €4.8 billion (2013: €3.8 billion) were outstanding as at 31 December 2014.

19 Interest rate futures

As at 31 December 2014 the following foreign currency transactions, presented at year-end market rates, were outstanding:

Foreign currency interest rate futures	2014 Contract value €	2013 Contract value €	Change €
Purchases	911,374,681	495,975,636	415,399,045
Sales	1,001,647,311	1,727,870,268	(726,222,957)

23 Decision ECB/2014/61 of 31 December 2014 on the paying-up of capital, transfer of foreign reserve assets and contributions by Lietuvos bankas to the European Central Bank's reserves and provisions, OJ L 50, 21.2.2015, p. 44; Agreement of 31 December 2014 between Lietuvos bankas and the European Central Bank regarding the claim credited to Lietuvos bankas by the European Central Bank under Article 30.3 of the Statute of the European System of Central Banks and of the European Central Bank, OJ C 64, 21.2.2015, p. 5.

These transactions were conducted in the context of the management of the ECB's foreign reserves.

20 Interest rate swaps

Interest rate swap transactions with a contract value of €270.8 million (2013: €252.0 million), presented at year-end market rates, were outstanding as at 31 December 2014. These transactions were conducted in the context of the management of the ECB's foreign reserves.

21 Forward transactions in securities

Forward purchases of securities in the amount of €245.2 million remained outstanding as at 31 December 2014. These transactions were conducted in the context of the management of the ECB's foreign reserves.

22 Foreign exchange swap and forward transactions

Foreign exchange swap and forward transactions were conducted in 2014 in the context of the management of the ECB's foreign reserves. The following forward claims and liabilities resulting from these transactions, presented at year-end market rates, remained outstanding as at 31 December 2014:

Foreign exchange swap and forward transactions	2014 €	2013 €	Change €
Claims	1,899,819,430	1,845,947,763	53,871,667
Liabilities	1,777,894,537	1,730,929,184	46,965,353

23 Administration of borrowing and lending operations

The ECB is responsible for the administration of the borrowing and lending operations of the EU under the medium-term financial assistance mechanism. In 2014 the ECB processed payments related to loans granted by the EU to Latvia, Hungary and Romania under this scheme.

In the context of the loan facility agreement between the Member States whose currency is the euro[24] and Kreditanstalt für Wiederaufbau,[25] as lenders, the Hellenic Republic, as the borrower, and the Bank of Greece, as the agent of the borrower, the ECB is responsible for processing all related payments on behalf of the lenders and the borrower.

24 Other than the Hellenic Republic and the Federal Republic of Germany.

25 Acting in the public interest, subject to the instructions of and with the benefit of the guarantee of the Federal Republic of Germany.

Furthermore, the ECB has an operational role in the administration of loans under the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). In 2014 the ECB processed payments in relation to loans granted to Ireland and Portugal under the EFSM scheme and loans granted to Ireland, Greece and Portugal under the EFSF scheme.

Moreover, the ECB administers payments in relation to the authorised capital stock and stability support operations of the European Stability Mechanism (ESM).[26] In 2014 the ECB processed payments from the Member States whose currency is the euro, in respect of the ESM's authorised capital stock, as well as payments from the ESM related to loans granted to Cyprus and Spain.

26 The Treaty establishing the European Stability Mechanism entered into force on 27 September 2012.

Notes on the Profit and Loss Account

24 Net interest income

24.1 Interest income on foreign reserve assets

This item includes interest income, net of interest expense, in respect of the ECB's net foreign reserve assets, as follows:

	2014 €	2013 €	Change €
Interest income on current accounts	571,710	601,611	(29,901)
Interest income on money market deposits	4,234,448	6,868,776	(2,634,328)
Interest income on reverse repurchase agreements	867,860	742,788	125,072
Net interest income on securities	206,165,493	172,250,735	33,914,758
Net interest income on interest rate swaps	407,588	1,833,740	(1,426,152)
Net interest income on foreign exchange swap and forward transactions	4,570,710	5,237,310	(666,600)
Total interest income on foreign reserve assets	**216,817,809**	**187,534,960**	**29,282,849**
Interest expense on current accounts	(23,076)	(42,758)	19,682
Net interest expense on repurchase agreements	208,426	(212,229)	420,655
Interest income on foreign reserve assets (net)	**217,003,159**	**187,279,973**	**29,723,186**

The overall increase in net interest income in 2014 was due mainly to higher interest income generated on the US dollar portfolio.

24.2 Interest income arising from the allocation of euro banknotes within the Eurosystem

This item consists of the interest income relating to the ECB's 8% share of the total euro banknote issue (see "Banknotes in circulation" in the notes on accounting policies and note 6.1, "Claims related to the allocation of euro banknotes within the Eurosystem"). Despite a 5.4% increase in the average value of banknotes in circulation, there was a decrease in income in 2014 owing to the fact that the average main refinancing rate was lower than in 2013 (at 0.16% in 2014, compared with 0.55% in 2013).

24.3 Remuneration of NCBs' claims in respect of foreign reserves transferred

Remuneration paid to euro area NCBs on their claims on the ECB in respect of the foreign reserve assets transferred under Article 30.1 of the Statute of the ESCB (see note 12.1, "Liabilities equivalent to the transfer of foreign reserves") is disclosed under this heading. The decrease in this remuneration in 2014 predominantly reflected the fact that the average main refinancing rate was lower than in 2013.

24.4 Other interest income; and other interest expense

In 2014 these items included interest income of €1.1 billion (2013: €4.7 billion) and expenses of €1.1 billion (2013: €4.7 billion) arising from TARGET2 balances (see note 12.2, “Other liabilities within the Eurosystem (net)”, and note 10, “Liabilities to non-euro area residents denominated in euro”).

They also included net interest income of €727.7 million (2013: €961.9 million) on the securities purchased by the ECB under the Securities Markets Programme, €174.2 million (2013: €204.2 million) on those purchased under the covered bond purchase programmes and €0.7 million (2013: €0 million) on those purchased under the asset-backed securities purchase programme. Interest income and interest expense in respect of other assets and liabilities denominated in euro are also shown under these headings.

25 Realised gains/losses arising from financial operations

Net realised gains arising from financial operations in 2014 were as follows:

	2014 €	2013 €	Change €
Net realised price gains	47,223,558	41,335,392	5,888,166
Net realised exchange rate and gold price gains	10,036,857	10,787,010	(750,153)
Net realised gains arising from financial operations	**57,260,415**	**52,122,402**	**5,138,013**

Net realised price gains included realised gains and losses on securities, interest rate futures and interest rate swaps. The overall increase in net realised price gains in 2014 was due mainly to higher realised price gains generated on securities in the US dollar portfolio.

26 Write-downs on financial assets and positions

Write-downs on financial assets and positions in 2014 were as follows:

	2014 €	2013 €	Change €
Unrealised price losses on securities	(7,664,489)	(114,606,755)	106,942,266
Unrealised price losses on interest rate swaps	(198,804)	(610)	(198,194)
Total write-downs	**(7,863,293)**	**(114,607,365)**	**106,744,072**

In 2014 the overall increase in the market value of the securities held in both the US dollar portfolio and the own funds portfolio resulted in substantially lower write-downs compared with 2013.

27 Net income/expense from fees and commissions

	2014 €	2013 €	Change €
Income from fees and commissions	30,024,834	25,917	29,998,917
Expenses relating to fees and commissions	(1,866,180)	(2,152,690)	286,510
Net income/expense from fees and commissions	**28,158,654**	**(2,126,773)**	**30,285,427**

In 2014 income under this heading consisted mainly of accrued supervisory fees (see note 28, “Income and expenses related to supervisory tasks”) and also included penalties imposed on credit institutions for non-compliance with the minimum reserve requirements. Expenses consisted of fees relating to current accounts and to interest rate futures transactions (see note 19, “Interest rate futures”).

28 Income and expenses related to supervisory tasks

On 4 November 2014 the ECB assumed its supervisory tasks in accordance with Article 33 of Council Regulation 1024/2013/EU of 15 October 2013.

The annual costs of the ECB in relation to its supervisory tasks will be recovered via the payment of annual supervisory fees. The supervisory fees cover, but do not exceed, the expenditure incurred by the ECB that is related to its supervisory tasks in the relevant fee period. This expenditure primarily consists of costs that are directly related to the ECB’s supervisory tasks, namely the costs of the new business areas that have been established for (a) the supervision of significant banks; (b) oversight of the supervision of less significant banks; and (c) horizontal tasks and specialised services. It also includes costs that are indirectly related to the ECB’s supervisory tasks, namely the costs of services provided by the ECB’s existing functions, including premises, human resources management and information technology services.

For 2014 the ECB will recover its costs for the period commencing in November 2014, which is when it assumed its supervisory tasks.

The related income of the ECB for November and December 2014, which will be invoiced in 2015, was as follows:

	2014 €	2013 €
Supervisory fees	29,973,012	-
of which:		
Fees levied on significant banks	*25,622,812*	-
Fees levied on less significant banks	*4,350,200*	-
Total income from banking supervision tasks	**29,973,012**	**-**

Income from supervisory fees is included under “Net income from fees and commissions” (see note 27, “Net income/expense from fees and commissions”).

In addition, the ECB is entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions. No such fines or penalties were imposed in 2014.

The expenditure incurred by the ECB for the period of November and December 2014 was as follows:

	2014 €	2013 €
Salaries and benefits	18,456,945	-
Rent and building maintenance	2,199,243	-
Other operating expenditure	9,316,824	-
Total expenditure related to banking supervision tasks	**29,973,012**	**-**

29 Income from equity shares and participating interests

Dividends received on shares which the ECB holds in the BIS (see note 7.2, "Other financial assets") are shown under this heading.

30 Other income

Other miscellaneous income during 2014 mainly arose from the accrued contributions of the euro area NCBs to the costs incurred by the ECB in connection with joint Eurosystem projects.

31 Staff costs

Salaries, allowances, staff insurance and other miscellaneous costs of €244.9 million (2013: €187.3 million) are included under this heading. Also included in this item is an amount of €56.2 million (2013: €53.3 million) recognised in connection with the ECB's pension plans, other post-employment benefits and other long-term benefits (see note 13.3, "Sundry"). Staff costs of €1.2 million (2013: €1.3 million) incurred in connection with the construction of the ECB's new premises have been capitalised and are excluded from this item.

Salaries and allowances, including the emoluments of holders of senior management positions, are modelled in essence on, and are comparable with, the remuneration scheme of the European Union.

Members of the Executive Board and the members of the Supervisory Board employed by the ECB receive a basic salary, while part-time members of the Supervisory Board employed by the ECB are also paid a variable salary, based on the number of meetings attended. In addition, the members of the Executive Board and the full-time members of the Supervisory Board employed by the ECB receive additional allowances for residence and representation. In the case of the President, an official residence owned by the ECB is provided in lieu of a residence allowance.

Subject to the Conditions of Employment for Staff of the European Central Bank, members of both boards are entitled to household, child and education allowances, depending on their individual circumstances. Basic salaries are subject to a tax for the benefit of the European Union as well as to deductions in respect of contributions to the pension, medical and accident insurance schemes. Allowances are non-taxable and non-pensionable.

In 2014 basic salaries paid to members of the Executive Board and members of the Supervisory Board employed by the ECB (i.e. excluding representatives of national supervisors) were as follows:

	2014 €	2013 €
Mario Draghi (President)	379,608	378,240
Vítor Constâncio (Vice-President)	325,392	324,216
Peter Praet (Board Member)	271,140	270,168
Jörg Asmussen (Board Member until January 2014)	*4,912*	*270,168*
Benoît Cœuré (Board Member)	271,140	270,168
Yves Mersch (Board Member)	271,140	281,833
Sabine Lautenschläger (Board Member since January 2014)	253,457	-
Total Executive Board	**1,776,789**	**1,794,793**
Total SSM Supervisory Board (members employed by the ECB)[27]	**508,589**	-
of which:		
Danièle Nouy (Chair of the Supervisory Board since January 2014)	271,140	-
Total	**2,285,378**	**1,794,793**

Furthermore, the variable salary paid to members of the Supervisory Board amounted to €74,776 (2013: €0).

The total allowances paid to members of both boards and the ECB’s contributions to the medical and accident insurance schemes on their behalf amounted to €674,470 (2013: €526,615).

In addition, benefits on appointment or termination of service paid to the members of both boards amounted to €68,616 (2013: €44,538). They are reported under “Administrative expenses” in the Profit and Loss Account.

Transitional payments may be made to former members of the Executive Board and the Supervisory Board for a limited period after the end of their terms of office. In 2014 these payments, the related family allowances and the ECB’s contributions to the medical and accident insurance schemes of former members amounted to €243,178 (2013: €618,189). Pension payments, including related allowances, to former board members or their dependents and contributions to the medical and accident insurance schemes amounted to €599,589 (2013: €472,891).

[27] With the exception of Sabine Lautenschläger whose salary is reported with those of the other members of the Executive Board.

At the end of 2014 the actual full-time equivalent number of staff holding contracts with the ECB was 2,577,[28] including 278 with managerial positions. The change in the number of staff during 2014 was as follows:

	2014	2013
Total staff as at 1 January	1,790	1,638
Newcomers/change of contractual status	1,458	496
Resignations/end of contract	(681)	(347)
Net increase due to changes in part-time working patterns	10	3
Total staff as at 31 December	**2,577**	**1,790**
Average number of staff employed	**2,155**	**1,683**

The increase in the number of staff in 2014 was mainly due to the preparations for the launch of the Single Supervisory Mechanism in November 2014.

32 Administrative expenses

These cover all other current expenses relating to the renting and maintenance of premises, goods and equipment of a non-capital nature, professional fees and other services and supplies, together with staff-related expenses including recruitment, relocation, installation, training and resettlement expenses. The preparations for the launch of the Single Supervisory Mechanism contributed to the increase in administrative expenses in 2014.

33 Banknote production services

This expense arises predominantly owing to the cross-border transportation of euro banknotes between banknote printing works and NCBs, for the delivery of new banknotes, and between NCBs, for the compensation of shortages with surplus stocks. These costs are borne centrally by the ECB.

28 Staff on unpaid leave are excluded. This number includes staff with permanent, fixed or short-term contracts and the participants in the ECB's Graduate Programme. Staff on maternity or long-term sick leave are also included.

Building a better
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President and Governing Council
of the European Central Bank
Frankfurt am Main

10 February 2015

Independent auditor's report

We have audited the accompanying annual accounts of the European Central Bank, which comprise the balance sheet as at 31 December 2014, the profit and loss account for the year then ended, and a summary of significant accounting policies and other explanatory notes (the "Annual Accounts").

The responsibility of the European Central Bank's Executive Board for the Annual Accounts
The Executive Board is responsible for the preparation and fair presentation of these Annual Accounts in accordance with the principles established by the Governing Council, which are set out in Decision ECB/2010/21 on the annual accounts of the European Central Bank, as amended, and for such internal control as the Executive Board determines is necessary to enable the preparation of the Annual Accounts that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility
Our responsibility is to express an opinion on these Annual Accounts based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the Annual Accounts are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Annual Accounts. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the Annual Accounts, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Annual Accounts in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Executive Board, as well as evaluating the overall presentation of the Annual Accounts.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the Annual Accounts give a true and fair view of the financial position of the European Central Bank as at 31 December 2014, and of the results of its operations for the year then ended in accordance with the principles established by the Governing Council, which are set out in Decision ECB/2010/21 on the annual accounts of the European Central Bank, as amended.

Yours sincerely,

Ernst & Young GmbH
Wirtschaftsprüfungsgesellschaft

Victor Veger
Certified Public Accountant

Claus-Peter Wagner
Wirtschaftsprüfer

Note on profit distribution/allocation of losses

This note is not part of the financial statements of the ECB for the year 2014.

Pursuant to Article 33 of the Statute of the ESCB, the net profit of the ECB shall be transferred in the following order:

(a) an amount to be determined by the Governing Council, which may not exceed 20% of the net profit, shall be transferred to the general reserve fund, subject to a limit equal to 100% of the capital; and

(b) the remaining net profit shall be distributed to the shareholders of the ECB in proportion to their paid-up shares.

In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the NCBs in accordance with Article 32.5 of the Statute of the ESCB.[1]

After the transfer to the risk provision, the ECB's net profit for 2014 was €988.8 million. Following a decision by the Governing Council, there was no transfer to the general reserve fund and an interim profit distribution, amounting to €840.7 million, was paid out to the euro area NCBs on 30 January 2015. Furthermore, the Governing Council decided to distribute the remaining profit of €148.1 million to the euro area NCBs.

Profits are distributed to the NCBs in proportion to their paid-up shares in the subscribed capital of the ECB. Non-euro area NCBs are not entitled to receive any share of the ECB's distributable profits, nor are they liable to fund any loss of the ECB.

	2014 €	2013 €
Profit for the year	988,832,500	1,439,769,100
Interim profit distribution	(840,719,787)	(1,369,690,567)
Retention owing to adjustments to profits earned in previous years	0	(9,503,000)
Profit for the year after the interim profit distribution and retention	148,112,713	60,575,533
Distribution of the remaining profit	(148,112,713)	(60,575,533)
Total	**0**	**0**

1 Under Article 32.5 of the Statute of the ESCB, the sum of the NCBs' monetary income shall be allocated to the NCBs in proportion to their paid-up shares in the capital of the ECB.

Consolidated balance sheet of the Eurosystem as at 31 December 2014[1]

(EUR millions)[2]

ASSETS		31 December 2014	31 December 2013
1	**Gold and gold receivables**	**343,630**	**302,940**
2	**Claims on non-euro area residents denominated in foreign currency**	**270,231**	**239,288**
	2.1 Receivables from the IMF	81,298	81,538
	2.2 Balances with banks and security investments, external loans and other external assets	188,932	157,750
3	**Claims on euro area residents denominated in foreign currency**	**27,940**	**22,464**
4	**Claims on non-euro area residents denominated in euro**	**18,905**	**20,101**
	4.1 Balances with banks, security investments and loans	18,905	20,101
	4.2 Claims arising from the credit facility under ERM II	0	0
5	**Lending to euro area credit institutions related to monetary policy operations denominated in euro**	**630,341**	**752,288**
	5.1 Main refinancing operations	156,129	168,662
	5.2 Longer-term refinancing operations	473,285	583,325
	5.3 Fine-tuning reverse operations	0	0
	5.4 Structural reverse operations	0	0
	5.5 Marginal lending facility	924	301
	5.6 Credits related to margin calls	2	0
6	**Other claims on euro area credit institutions denominated in euro**	**59,939**	**74,849**
7	**Securities of euro area residents denominated in euro**	**589,511**	**589,763**
	7.1 Securities held for monetary policy purposes	217,242	235,930
	7.2 Other securities	372,269	353,834
8	**General government debt denominated in euro**	**26,715**	**28,287**
9	**Other assets**	**241,042**	**243,286**
	Total assets	**2,208,253**	**2,273,267**

1 Based on provisional unaudited data. The annual accounts of all the NCBs will be finalised by the end of May 2015 and the final consolidated annual balance sheet of the Eurosystem will be published thereafter.

2 Totals/subtotals may not add up due to rounding.

LIABILITIES		31 December 2014	31 December 2013
1	**Banknotes in circulation**	**1,016,616**	**956,185**
2	**Liabilities to euro area credit institutions related to monetary policy operations denominated in euro**	**366,511**	**473,155**
	2.1 Current accounts (covering the minimum reserve system)	318,245	282,578
	2.2 Deposit facility	48,266	85,658
	2.3 Fixed-term deposits	0	104,842
	2.4 Fine-tuning reverse operations	0	0
	2.5 Deposits related to margin calls	0	77
3	**Other liabilities to euro area credit institutions denominated in euro**	**4,635**	**3,014**
4	**Debt certificates issued**	**0**	**0**
5	**Liabilities to other euro area residents denominated in euro**	**64,523**	**91,108**
	5.1 General government	36,770	65,871
	5.2 Other liabilities	27,753	25,237
6	**Liabilities to non-euro area residents denominated in euro**	**47,927**	**115,416**
7	**Liabilities to euro area residents denominated in foreign currency**	**1,271**	**4,589**
8	**Liabilities to non-euro area residents denominated in foreign currency**	**4,753**	**2,998**
	8.1 Deposits, balances and other liabilities	4,753	2,998
	8.2 Liabilities arising from the credit facility under ERM II	0	0
9	**Counterpart of special drawing rights allocated by the IMF**	**56,211**	**52,717**
10	**Other liabilities**	**221,055**	**219,587**
11	**Revaluation accounts**	**330,733**	**262,633**
12	**Capital and reserves**	**94,020**	**91,864**
	Total liabilities	**2,208,253**	**2,273,267**

Annex 1
Institutional framework

1 Decision-making bodies and corporate governance of the ECB

The Eurosystem and the ESCB are governed by the decision-making bodies of the ECB: the Governing Council and the Executive Board. The General Council is constituted as a third decision-making body of the ECB, for as long as there are EU Member States which have not yet adopted the euro. The functioning of the decision-making bodies is governed by the Treaty on European Union, the Treaty on the Functioning of the European Union, the Statute of the ESCB and the relevant Rules of Procedure.[1] Decision-making within the Eurosystem and the ESCB is centralised. However, the ECB and the euro area NCBs jointly contribute, strategically and operationally, to attaining the common goals of the Eurosystem, with due respect to the principle of decentralisation in accordance with the Statute of the ESCB.

1.1 The Governing Council

The Governing Council is the main decision-making body of the ECB. It comprises the members of the Executive Board of the ECB and the governors of the NCBs of the euro area countries. In view of Lithuania's adoption of the euro as of January 2015, the Chairman of the Board of Lietuvos bankas, the central bank of Lithuania, was invited to attend the meetings of the Governing Council in an observer capacity between July and December 2014.

In July 2014 the Governing Council decided that meetings dedicated to monetary policy would be held every six weeks instead of once a month, starting in January 2015.

[1] For the ECB's Rules of Procedure, see: Decision ECB/2004/2 of 19 February 2004 adopting the Rules of Procedure of the European Central Bank, OJ L 80, 18.3.2004, p. 33; Decision ECB/2004/12 of 17 June 2004 adopting the Rules of Procedure of the General Council of the ECB, OJ L 230, 30.6.2004, p. 61; and Decision ECB/1999/7 of 12 October 1999 concerning the Rules of Procedure of the Executive Board of the ECB, OJ L 314, 8.12.1999, p. 34. These rules are also available on the ECB's website.

The Governing Council

Mario Draghi	President of the ECB
Vítor Constâncio	Vice-President of the ECB
Jörg Asmussen	Member of the Executive Board of the ECB (until 7 January 2014)
Josef Bonnici	Governor of the Central Bank of Malta
Luc Coene	Governor of the Nationale Bank van België/Banque Nationale de Belgique
Benoît Cœuré	Member of the Executive Board of the ECB
Carlos Costa	Governor of the Banco de Portugal
Panicos O. Demetriades	Governor of the Central Bank of Cyprus (until 10 April 2014)
Chrystalla Georghadji	Governor of the Central Bank of Cyprus (from 11 April 2014)
Ardo Hansson	Governor of Eesti Pank
Patrick Honohan	Governor of the Central Bank of Ireland
Boštjan Jazbec	Governor of Banka Slovenije
Klaas Knot	President of De Nederlandsche Bank
Sabine Lautenschläger	Member of the Executive Board of the ECB (from 27 January 2014)
Erkki Liikanen	Governor of Suomen Pankki – Finlands Bank
Luis M. Linde	Governor of the Banco de España
Jozef Makúch	Governor of Národná banka Slovenska
Yves Mersch	Member of the Executive Board of the ECB
Ewald Nowotny	Governor of the Oesterreichische Nationalbank
Christian Noyer	Governor of the Banque de France
Peter Praet	Member of the Executive Board of the ECB
George A. Provopoulos	Governor of the Bank of Greece (until 19 June 2014)
Gaston Reinesch	Governor of the Banque centrale du Luxembourg
Ilmārs Rimšēvičs	Governor of Latvijas Banka
Yannis Stournaras	Governor of the Bank of Greece (from 26 June 2014)
Vitas Vasiliauskas	Chairman of the Board of Lietuvos bankas (from 1 January 2015)
Ignazio Visco	Governor of the Banca d’Italia
Jens Weidmann	President of the Deutsche Bundesbank

Front row (from left to right): Ignazio Visco, Carlos Costa, Chrystalla Georghadji, Vítor Constâncio, Mario Draghi, Sabine Lautenschläger, Patrick Honohan, Luis M. Linde

Middle row (from left to right): Josef Bonnici, Boštjan Jazbec, Luc Coene, Jozef Makúch, Christian Noyer

Back row (from left to right): Ewald Nowotny, Benoît Cœuré, Vitas Vasiliauskas, Klaas Knot, Gaston Reinesch, Ardo Hansson, Erkki Liikanen

Note: Yves Mersch, Peter Praet, Ilmārs Rimšēvičs, Yannis Stournaras and Jens Weidmann were not available at the time the photograph was taken.

1.2 The Executive Board

The Executive Board comprises the President and the Vice-President of the ECB and four other members appointed by the European Council, acting by qualified majority, after consultation with the European Parliament and the ECB.

The Executive Board

Mario Draghi	President of the ECB
Vítor Constâncio	Vice-President of the ECB
Jörg Asmussen	Member of the Executive Board of the ECB (until 7 January 2014)
Benoît Cœuré	Member of the Executive Board of the ECB
Sabine Lautenschläger	Member of the Executive Board of the ECB (from 27 January 2014)
Yves Mersch	Member of the Executive Board of the ECB
Peter Praet	Member of the Executive Board of the ECB

Front row (left to right): Sabine Lautenschläger, Mario Draghi (President), Vítor Constâncio (Vice-President)

Back row (left to right): Yves Mersch, Peter Praet, Benoît Cœuré

1.3 The General Council

The General Council is composed of the President and the Vice-President of the ECB and the governors of the NCBs of all 28 EU Member States.

The General Council

Mario Draghi	President of the ECB
Vítor Constâncio	Vice-President of the ECB
Marek Belka	President of Narodowy Bank Polski
Josef Bonnici	Governor of the Central Bank of Malta
Mark Carney	Governor of the Bank of England
Luc Coene	Governor of the Nationale Bank van België/ Banque Nationale de Belgique
Carlos Costa	Governor of the Banco de Portugal
Panicos O. Demetriades	Governor of the Central Bank of Cyprus (until 10 April 2014)
Chrystalla Georghadji	Governor of the Central Bank of Cyprus (from 11 April 2014)
Ardo Hansson	Governor of Eesti Pank
Patrick Honohan	Governor of the Central Bank of Ireland
Stefan Ingves	Governor of Sveriges Riksbank
Mugur Constantin Isărescu	Governor of Banca Naţională a României

Ivan Iskrov	Governor of Българска народна банка (Bulgarian National Bank)
Boštjan Jazbec	Governor of Banka Slovenije
Klaas Knot	President of De Nederlandsche Bank
Erkki Liikanen	Governor of Suomen Pankki – Finlands Bank
Luis M. Linde	Governor of the Banco de España
Jozef Makúch	Governor of Národná banka Slovenska
György Matolcsy	Governor of the Magyar Nemzeti Bank
Ewald Nowotny	Governor of the Oesterreichische Nationalbank
Christian Noyer	Governor of the Banque de France
George A. Provopoulos	Governor of the Bank of Greece (until 19 June 2014)
Gaston Reinesch	Governor of the Banque centrale du Luxembourg
Ilmārs Rimšēvičs	Governor of Latvijas Banka
Lars Rohde	Governor of Danmarks Nationalbank
Miroslav Singer	Governor of Česká národní banka
Yannis Stournaras	Governor of the Bank of Greece (from 26 June 2014)
Vitas Vasiliauskas	Chairman of the Board of Lietuvos bankas
Ignazio Visco	Governor of the Banca d'Italia
Boris Vujčić	Governor of Hrvatska narodna banka
Jens Weidmann	President of the Deutsche Bundesbank

Front row (left to right): Boris Vujčić, Liviu Voinea (Deputy Governor Banca Naţională a României), Stefan Ingves, Chrystalla Georghadji, Vítor Constâncio, Mario Draghi, Ben Broadbent (Deputy Governor Bank of England), Patrick Honohan, Luis M. Linde, Lars Rohde

Middle row (left to right): Ignazio Visco, Carlos Costa, Josef Bonnici, Boštjan Jazbec, Luc Coene, Jozef Makúch, Christian Noyer

Back row (left to right): Marek Belka, Ivan Iskrov, Ewald Nowotny, Vitas Vasiliauskas, Klaas Knot, Gaston Reinesch, Ardo Hansson, Jens Weidmann, Erkki Liikanen

Note: Mark Carney, Mugur Constantin Isărescu, György Matolcsy, Ilmārs Rimšēvičs, Miroslav Singer and Yannis Stournaras were not available at the time the photograph was taken.

1.4 Corporate governance

In addition to the decision-making bodies, the corporate governance of the ECB encompasses high-level committees such as the ECB Audit Committee and the ECB Ethics Committee as well as a number of external and internal control layers.

ECB Audit Committee

The ECB Audit Committee enhances the corporate governance of the ECB and of the Eurosystem as a whole. It supports the Governing Council by providing advice and/or opinions regarding its responsibilities in respect of (i) the integrity of financial information, (ii) the oversight of internal controls, (iii) compliance with applicable laws, regulations and codes of conduct, and (iv) the performance of audit functions. Its mandate is available on the ECB's website. The Audit Committee is chaired by Erkki Liikanen and comprises four other members: Vítor Constâncio, Christian Noyer, Hans Tietmeyer and Jean-Claude Trichet.

External control layers

The Statute of the ESCB provides for two control layers, namely the external auditor[2], which is appointed to audit the annual accounts of the ECB, and the European Court of Auditors, which examines the operational efficiency of the management of the ECB.

Internal control layers

Other key components of the ECB's corporate governance structure are the internal control structure of the ECB, the Ethics Framework and the rules concerning public access to ECB documents.

The internal control structure of the ECB is based on a functional approach in which each organisational unit (section, division, directorate or directorate general) has primary responsibility for managing its own risks, as well as for ensuring the effectiveness and efficiency of its operations. It also comprises monitoring mechanisms and effective processes to achieve adequate control of financial and operational risks. A more detailed description of these control mechanisms and procedures is provided in the management report, which can be found in the Annual Accounts 2014 section.

Independently from the internal control structure and risk monitoring of the ECB, audit missions are performed by the internal audit function under the direct responsibility of the Executive Board, in accordance with the ECB Audit Charter[3].

ECB Ethics Framework

The ECB's Ethics Framework consists of the Code of Conduct for the members of the Governing Council, the Supplementary Code of Ethics Criteria for the members of the Executive Board, the Code of Conduct for the members of the Supervisory Board and the ECB Staff Rules, as amended on 3 December 2014 following the establishment of the Single Supervisory Mechanism (SSM).

The Ethics Framework sets ethical rules and guiding principles to ensure the highest level of integrity, competence, efficiency and transparency in the performance of tasks. Following the establishment of the SSM, governance issues have acquired increased significance for the ECB. To ensure the adequate and consistent implementation of the Ethics Framework in place and to enhance the ECB's corporate governance, on 17 December 2014 the Governing Council decided to establish an Ethics Committee. Finally, a Compliance and Governance Office was established to support the Executive Board in protecting the integrity and reputation of the ECB, to promote ethical standards of behaviour and to strengthen the ECB's accountability and transparency.

2 Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft for the financial years 2013-17.

3 This charter is published on the ECB's website to foster the transparency of audit arrangements in place at the ECB.

ECB Ethics Committee

The Ethics Committee will provide, among other things, advice on questions of ethics on the basis of individual requests and will assume the responsibilities assigned to the Ethics Adviser under the Code of Conduct for the members of the Governing Council and the Ethics Officer under the Supplementary Code of Ethics Criteria for the members of the Executive Board. The Ethics Committee will be composed of three external members, at least one of which will be an external member of the ECB's Audit Committee. The members of the Ethics Committee must be individuals of high repute from Member States, whose independence is beyond doubt and who have a sound understanding of the objectives, tasks and governance of the ECB, the ESCB, the Eurosystem and the SSM.

1.5 Public access to ECB documents

The ECB's Decision on public access to ECB documents[4] is in line with the objectives and standards applied by other EU institutions and bodies with regard to public access to their documents. It enhances transparency, while at the same time taking into account the independence of the ECB and of the NCBs and ensuring the confidentiality of certain matters specific to the performance of the ECB's tasks.[5] In 2014 the number of public access requests remained limited.

[4] Decision ECB/2004/3 of 4 March 2004 on public access to European Central Bank documents, OJ L 80, 18.3.2004, p. 42.

[5] In line with the ECB's commitment to openness and transparency, the "Archives" section of the ECB's website provides access to historical documentation.

Annex 2
Eurosystem/ESCB committees

The Eurosystem/ESCB committees have continued to play an important role in assisting the ECB's decision-making bodies in the performance of their tasks. At the request of both the Governing Council and the Executive Board, the committees have provided expertise in their fields of competence and have facilitated the decision-making process. Membership of the committees is usually restricted to staff of the Eurosystem central banks. However, the NCBs of the Member States which have not yet adopted the euro take part in the meetings of a committee whenever it deals with matters that fall within the field of competence of the General Council. In addition, some of the committees meet in an SSM composition (i.e. one member from the central bank and one member from the national competent authority of each participating Member State) when dealing with matters related to banking supervision. Where appropriate, other competent bodies may also be invited to committee meetings.

EUROSYSTEM/ESCB COMMITTEES, EUROSYSTEM IT STEERING COMMITTEE, BUDGET COMMITTEE, HUMAN RESOURCES CONFERENCE AND THEIR CHAIRPERSONS

(as at 1 January 2015)

- **Accounting and Monetary Income Committee (AMICO)** – Werner Studener
- **Banknote Committee (BANCO)** – Ton Roos
- **Committee on Controlling (COMCO)** – Pentti Hakkarainen
- **Eurosystem/ESCB Communications Committee (ECCO)** – Christine Graeff
- **Financial Stability Committee (FSC)** – Vítor Constâncio
- **Information Technology Committee (ITC)** – Koenraad de Geest
- **Internal Auditors Committee (IAC)** – Klaus Gressenbauer
- **Budget Committee (BUCOM)** – José Luis Malo de Molina
- **Eurosystem IT Steering Committee (EISC)** – Vítor Constâncio
- **International Relations Committee (IRC)** – Frank Moss
- **Legal Committee (LEGCO)** – Chiara Zilioli
- **Market Operations Committee (MOC)** – Ulrich Bindseil
- **Monetary Policy Committee (MPC)** – Wolfgang Schill
- **Organisational Development Committee (ODC)** – Steven Keuning
- **Payment and Settlement Systems Committee (PSSC)** – Marc Bayle/Daniela Russo
- **Risk Management Committee (RMC)** – Carlos Bernadell
- **Statistics Committee (STC)** – Aurel Schubert
- **Human Resources Conference (HRC)** – Steven Keuning

Three further committees exist. The Budget Committee assists the Governing Council in matters related to the ECB's budget. The Human Resources Conference is a forum for the exchange of experience, expertise and information among Eurosystem/ESCB central banks in the field of human resources management. The Eurosystem IT Steering Committee, which was established in 2007 with a mandate to steer continuous improvement in the use of IT within the Eurosystem, became a dormant committee in November 2014. Its operational tasks were assigned to other relevant committees, i.e. the Committee on Controlling, the Information Technology Committee and the Organisational Development Committee.

Annex 3
Organisational and human resources developments

THE ORGANISATION CHART OF THE ECB
(as at 1 January 2015)

Directorate General Administration
Werner Studener
Deputy: Klaus Riemke
Divisions:
- Accounting & Procurement
- Administrative Services
- Financial Reporting & Policy
- Premises
- Security & Safety

Directorate Banknotes
Ton Roos
Divisions:
- Currency Development
- Currency Management

Directorate General Communications & Language Services
Christine Graeff
Deputy: Thierry Bracke
Deputy: Cornelia Lotze
Divisions:
- Global Media Relations
- Language Services
- Multimedia
- Outreach & Protocol

Counsel to the Executive Board
Frank Smets

ECB Representation in Washington, D.C.
Georges Pineau

Directorate General Economics
Wolfgang Schill
Deputy: Hans-Joachim Klöckers
- **Directorate Economic Developments**
  Hans-Joachim Klöckers
  Divisions:
  - Convergence & Competitiveness
  - Country Surveillance
  - Fiscal Policies
  - Output & Demand
  - Prices & Costs
- **Directorate Monetary Policy**
  Massimo Rostagno
  Divisions:
  - Capital Markets/Financial Structure
  - Monetary Analysis
  - Monetary Policy Strategy

ESRB Secretariat[1]
Francesco Mazzaferro
Deputy: N.N.

Directorate General HR, Budget & Organisation
Steven Keuning
Deputy: Peter Rennpferdt
Divisions:
- Budget, Controlling & Organisation
- HR Policies & Staff Relations
- Recruitment & Compensation

Directorate General Information Systems
Koenraad De Geest
Deputy: Magí Clavé Badia
Deputy: Dirk Robijns
Divisions:
- Analytical Domain Applications
- Enterprise Systems
- Executional Domain Applications
- Infrastructure & Operations
- IT Governance and Business Relations
- Security & Architecture

Directorate Internal Audit
Klaus Gressenbauer
Divisions:
- Audit Missions
- Audit Services

Directorate General International & European Relations
Frank Moss
Deputy: Gilles Noblet
Divisions:
- EU Institutions & Fora (includes the ECB Representative Office in Brussels)
- External Developments
- International Policy Analysis
- International Relations & Cooperation

Directorate General Legal Services
Chiara Zilioli
Deputy: Petra Senkovic
Divisions:
- Financial Law
- Institutional Law[2]
- Legislation
- Supervisory Law

Directorate General Macro-Prudential Policy & Financial Stability
Sergio Nicoletti Altimari
Deputy: John Fell
Divisions:
- Financial Regulation
- Financial Stability Surveillance
- Macro-Financial Linkages
- Macro-Financial Policies

Directorate General Market Infrastructure & Payments
Marc Bayle
Deputy: Pierre Petit
Divisions:
- Market Infrastructure Development
- Market Infrastructure Management
- Market Integration
- Oversight

Directorate General Market Operations
Ulrich Bindseil
Deputy: Roberto Schiavi
Divisions:
- Bond Markets & International Operations
- Financial Operations Services
- Market Operations Analysis
- Market Operations Systems
- Money Market & Liquidity

Directorate General Research
N.N.
Deputy: Philipp Hartmann
Divisions:
- Financial Research
- Monetary Policy Research

Directorate Risk Management
Carlos Bernadell
Divisions:
- Risk Analysis
- Risk Strategy

Directorate General Secretariat
Pierre van der Haegen[3]
Divisions:
- Information Management Services
- Secretariat
- **Compliance and Governance Office**
  N.N.

Directorate General Statistics
Aurel Schubert
Deputy: Werner Bier
Divisions:
- External Statistics
- Macroeconomic Statistics
- Monetary & Financial Statistics
- Statistical Information Services
- Statistics Development/ Coordination
- Supervisory Statistics

Directorate Secretariat to the Supervisory Board
Pedro Gustavo Teixeira

Directorate General Micro-Prudential Supervision I
Stefan Walter
Deputy: Patrick Amis
Deputy: Margarita Delgado
Divisions:
- Significant Bank Supervision I
- Significant Bank Supervision II
- Significant Bank Supervision III
- Significant Bank Supervision IV
- Significant Bank Supervision V
- Significant Bank Supervision VI
- Significant Bank Supervision VII

Directorate General Micro-Prudential Supervision II
Ramón Quintana
Deputy: Paolo Corradino
Deputy: Rolf Klug
Divisions:
- Significant Bank Supervision VIII
- Significant Bank Supervision IX
- Significant Bank Supervision X
- Significant Bank Supervision XI
- Significant Bank Supervision XII
- Significant Bank Supervision XIII
- Significant Bank Supervision XIV
- Significant Bank Supervision XV

Directorate General Micro-Prudential Supervision III
Jukka Vesala
Deputy: Linette Field
Divisions:
- Analysis and Methodological Support
- Institutional and Sectoral Oversight
- Supervisory Oversight & NCA Relations

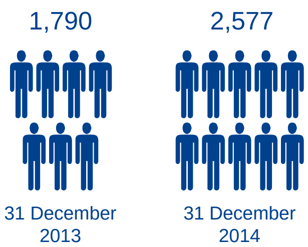
Directorate General Micro-Prudential Supervision IV
Korbinian Ibel
Deputy: François-Louis Michaud
Deputy: Giuseppe Siani
Divisions:
- Authorisation
- Centralised On-site Inspections
- Crisis Management
- Enforcement & Sanctions
- Internal Models
- Methodology & Standards Development
- Planning & Coordination of SEP
- SSM Risk Analysis
- Supervisory Policies
- Supervisory Quality Assurance

1 Reports to the President of the ECB in his capacity as Chair of the European Systemic Risk Board (ESRB).
2 Includes the data protection function.
3 Secretary to the Executive Board, the Governing Council and the General Council.

ECB human resources

2014 was an extraordinary year for the ECB in the field of human resources developments, with a particular focus being placed on recruitment and staff development for the launch of the Single Supervisory Mechanism (SSM) on 4 November 2014. Gender diversity was also a focal point, with the proportion of women in high-ranking positions increasing in 2014.

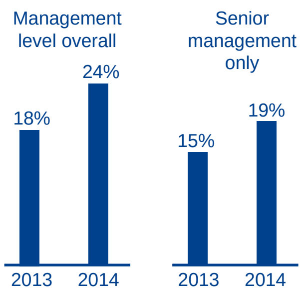
Actual full-time equivalent staff holding employment contracts



As at 31 December 2014 the ECB had 2,622 full-time equivalent approved headcount positions, compared with 1,907 positions at the end of 2013. The large majority of additional positions approved in relation to the establishment of the SSM were filled by 31 December 2014, with the number of actual full-time equivalent staff holding employment contracts with the ECB standing at 2,577 (compared with 1,790 on 31 December 2013).[1] A total of 779 new fixed-term contracts (limited in nature[2] or convertible to permanent contracts) were offered in 2014 and 506 short-term contracts were issued during the year, in addition to a number of contract extensions, to cover absences of less than one year. Throughout 2014 the ECB continued to offer short-term contracts for periods of up to 36 months to staff from NCBs and international organisations. On 31 December 2014 151 employees from NCBs and international organisations were working at the ECB on various assignments, 26% less than at the end of 2013. In September 2014 the ECB welcomed ten participants in the ninth intake of its Graduate Programme, and on 31 December 2014 155 trainees were being hosted by the ECB (7% more than in 2013). The ECB also awarded four fellowships as part of the Wim Duisenberg Research Fellowship Programme, which is open to leading economists, and five fellowships to young researchers under its Lamfalussy Fellowship Programme.

Staff development remained an important issue at the ECB. 2014 saw a particular emphasis on the development and rollout of the SSM training curriculum and a large increase in “knowledge-sharing” training programmes for newcomers. The two-year career transition support programme came to a successful end, with 45 long-serving members of staff taking up the support provided to pursue their career outside the ECB. In addition, a women’s leadership training programme was launched in 2014.

Women in positions at management level



Following the decision of the Executive Board in June 2013 to introduce gender targets for women at management and senior management level, the representation of women in this group has increased. At the end of 2014 24% of positions at management level and 19% of positions at senior management level were held by women (compared with 18% and 15% respectively at the end of 2013). In parallel with the decision to establish gender targets, the Executive Board also endorsed a gender diversity action plan consisting of a series of operational measures and instruments (e.g. diversity ambassadors, a mentoring programme and additional teleworking opportunities), which were all subsequently implemented.

1 In addition to contracts based on full-time equivalent positions, this figure includes short-term contracts awarded to staff seconded from NCBs and international organisations and contracts awarded to Graduate Programme participants.

2 Some non-convertible contracts were issued, in particular in ECB shared services, in order to cover the temporary tasks of launching the SSM.

The ECB continues to support the needs of staff in achieving a work-life balance. At the end of 2014 259 staff members were working part time (228 at end-2013) and 29 staff members were on unpaid parental leave (26 at end-2013). In 2014, on average, around 781 staff members teleworked at least once a month.

While the organisation grew in size, 53 members of staff employed on a fixed-term or permanent basis resigned or retired in 2014 (42 in 2013), while 396 short-term contracts expired in the course of the year.

The ECB’s new premises

In 2014 the ECB moved into its new headquarters, marking the successful completion of a 16-year process.

The ECB launched a search for a suitable site for its own premises back in 1998, following a recommendation from the European Court of Auditors to all EU institutions that it is more economical in the long term to own premises rather than to rent office space. Having looked at 35 possible options across Frankfurt, the ECB decided in 2001 to purchase the site of the Grossmarkthalle, the city’s former wholesale market hall, and to retain the existing building. A feasibility study had shown that this site was the most economically viable, that it was well connected in terms of infrastructure, that the spatial requirements could be met and that it was the optimal site for implementing the security measures required by a central bank. Furthermore, it offered sufficient space for further construction and extension.

The design was developed by Vienna-based architects COOP HIMMELB(L)AU. It creates a working environment that facilitates open communication, promoting teamwork and interaction at every level. At the same time, the degree of flexibility in the design means that changing requirements can be accommodated with little effort.

The distinctive glass office tower, which is linked to the market hall building via an entrance building, serves as a landmark in Frankfurt’s Ostend district, and the new building ensemble is a notable addition to Europe’s architectural heritage.

The Grossmarkthalle was built between 1926 and 1928 to serve as a central location for buying and selling fruit and vegetables in Frankfurt and the surrounding area. As an industrial building, it heralded Frankfurt’s ascent to the rank of metropolis during the 1920s. Martin Elsaesser, who was Director of Town Planning for the City of Frankfurt am Main at the time, designed the Grossmarkthalle as the world’s largest free-spanning reinforced concrete structure.

The construction process included converting this industrial utility building into a public institution with an array of functions, which required the highest degree of care. From the outset, all decisions on the design, as well as its further development, were discussed in detail and taken in close cooperation with both the City of Frankfurt am Main and the historic preservation authorities. Converting the city’s former wholesale market hall and incorporating it into the design has made history part of the ECB, adding to the uniqueness of this landmark.

The ECB has aimed from the start to create a sustainable building that is highly efficient in terms of energy and water consumption. Various energy design measures have been put in place to ensure that the new building is 30% more efficient than stipulated by the Energieeinsparverordnung (German energy saving directive) of 2007.

2014 saw the finalisation of the construction works for the new premises. The installation of technical infrastructure and the fit-out works were completed inside the buildings, while construction of the two elements linking the Grossmarkthalle and the high-rise took place in the spring. Each floor was divided up into offices of various sizes using lightweight walls, and the furniture began to be set up from April. Headway was also made on the realisation of the landscape design in areas of the site that had already been cleared. Groups of trees, embankments and ditches began to take shape, with the landscaping work due to be completed in 2015.

The procedure for obtaining formal building acceptance from the City authorities began in spring 2014. All technical systems were thoroughly tested over the summer, and a completely new IT infrastructure was installed in parallel. In the autumn the ECB received formal permission from the City authorities to operate the building.

Finally, from 31 October to 23 November, 2,421 workplaces were successfully moved. This marked the successful completion of the process to build a functional, sustainable and modern headquarters for the ECB. The majority of staff members dealing with monetary policy are now working together under one roof. However, since the new premises were designed at a time when it was not foreseen that the ECB would assume responsibility for banking supervision in the euro area, the ECB decided in November 2013 to continue to rent its former headquarters to house its banking supervision staff. Staff providing shared services are located in both buildings.