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Resolution strategy for SIFI groups

- Legislation must allow the resolution of systemically important groups, SIFIs, as single entities and support of this strategy by an MREL for the whole group. The conditions for exempting mortgage banks from bail-in and MREL are not met.
- A failing SIFI group should be resolved as a single entity due to its deeply integrated financial and technical structures. A single point of entry, SPE, resolution strategy must be supported by an MREL for the group as a whole.
- The MREL must be set so as to ensure that it is risk-based, robust and competition-neutral.

Background

The Danish Financial Supervisory Authority has announced that it should be possible to restructure systemic financial institutions and return them to the market with sufficient capital to ensure market confidence.¹ The Danish Financial Supervisory Authority has also announced the intended resolution procedure for small and medium-sized banks.² It has not yet been decided how the resolution authorities plan to resolve failing mortgage banks and SIFI groups comprising both banks and mortgage banks.

Credible and practicable resolution plans for the SIFI groups are an essential precondition for maintaining financial stability in a crisis situation without the use of government funds. Crisis situations may arise unexpectedly and swiftly, so a credible plan for addressing apparently unlikely situations must be in place. The financial crisis emphasised that, in the absence of a credible alternative, the government will be forced to intervene using government funds. Hence, resolution planning is a precondition for limiting the consequences of a SIFI group's failure for the economy overall.

1 Cf. <https://www.finanstilsynet.dk/en/Nyheder-og-Presse/Pressemeddelelser/2017/PM-Foreloebige-principper-for-afviklingsplaner-og-nep-krav-systemiske-pengeinstitutter>.

2 Cf. https://www.finanstilsynet.dk/en/Nyheder-og-Presse/Pressemeddelelser/2017/Resolution_strategy_and_MREL_for_small_and_medium-sized_banks.

Resolution strategy for SIFI groups

The internal business, financial and technical structures of the Danish SIFI groups are deeply integrated. This is also true of the groups' mortgage banks, which are closely integrated with the rest of the group. Therefore, in Danmarks Nationalbank's opinion, the preferred resolution strategy for the Danish SIFI groups should be an SPE resolution strategy by which the group, including the mortgage bank, is resolved as a single entity. The mortgage banks carry out functions that are critical to society as a whole, including issuing new loans, which must be continued in a resolution. At the same time, liquidation of a mortgage bank entails a considerable risk of a knock-on effect on the rest of the sector. Therefore, in Danmarks Nationalbank's assessment, it is not credible to plan on the possibility that the mortgage banks can be resolved separately, or that they can be liquidated according to the insolvency proceedings of mortgage credit legislation.

It must be regarded as key to the resolution plans that a mortgage bank which is failing or likely to fail can be recapitalised and its functions continue.

In order to ensure a credible and practicable SPE resolution strategy without the use of government funds, the Danish Financial Supervisory Authority must see that the individual institutions and the group overall have sufficient own funds and other eligible liabilities for both loss absorption and recapitalisation with a view to ensuring that the group can be recapitalised and thus that its critical functions can be continued.³

Hence, an MREL must be set for both the group and the individual institutions to support an SPE resolution strategy.⁴ MREL for subsidiaries in the group, called internal MREL, should be issued to the parent undertaking. This is to ensure that the

Concepts

SIFIs – Systemically important financial institutions
SIFIs are financial institutions characterised by undertaking activities of importance to the overall economy. The identification of SIFIs is described in sections 308 and 310 of the Danish Financial Business Act.

The following have been identified as SIFIs: Danske Bank, Nykredit Realkredit, Nordea Kredit, Jyske Bank, Sydbank and DLR Kredit.

Bail-in

The concept of bail-in means that subordinated and senior unsecured liabilities are written down or converted to shares or other equity in order to absorb losses and/or recapitalise a failing financial institution, cf. also section 24 of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises. Bail-in may also be used together with other resolution tools – bridge institution, sale of business or asset separation. Bail-in thus enables losses to be borne by unsecured creditors.

BRRD – Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms

The objective of the BRRD is to ensure that government funds, as far as possible, are not used to deal with failing institutions or institutions likely to fail. In addition, uniform powers for supervisory and resolution authorities are ensured. The BRRD was implemented into Danish law by Act no. 334 of 31 March 2015 amending the Danish Financial Business Act etc. and Act no. 333 of 31 March 2015 on Restructuring and Resolution of Certain Financial Enterprises. In that connection, the Danish Parliament decided to make use of the option under the BRRD to exempt mortgage banks from bail-in and MREL as an absolute exemption, cf. section 266(1) of the Danish Financial Business Act and section 24(4) of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.

MREL – Minimum requirement for own funds and eligible liabilities

Own funds and eligible liabilities are equity and debt instruments suitable for absorbing losses and recapitalising an institution in a resolution. The purpose of imposing MREL on the institutions is to ensure that they have sufficient own funds and liabilities for loss absorption and recapitalisation in accordance with the resolution strategy chosen. Moreover, the MREL ensures that institutions do not structure their liabilities in such a way that bail-in becomes less efficient, cf. also sections 266-268 of the Danish Financial Business Act.

³ Cf. sections 266-268 of the Danish Financial Business Act and Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities.

⁴ Cf. section 266(1) and (3) of the Danish Financial Business Act.

parent undertaking is sufficiently exposed to its subsidiaries to enable transfer of losses in subsidiaries to the parent undertaking. This is crucial in order to keep the group together in a resolution⁵.

Special aspects of resolution of mortgage banks

Under Danish law, the resolution authorities are prevented from applying the bail-in tool to mortgage banks.⁶ The background is the assessment in the Danish implementation of the BRRD that mortgage banks can always be resolved without use of the bail-in tool, but rather by means of other resolution tools and/or insolvency proceedings. As a consequence, mortgage banks were exempted from having to meet an MREL.⁷

The exemption is based on a provision in the BRRD allowing the national authorities to specifically exempt mortgage banks from the MREL if national insolvency proceedings or resolution tools other than bail-in are used and ensure that losses are borne by the institution's creditors in accordance with the resolution objectives stipulated in the BRRD.⁸ If insolvency proceedings as a backstop for resolution of mortgage banks do not meet the resolution objectives, the conditions for exempting mortgage banks from bail-in and MREL are not met. It is Danmarks Nationalbank's clear assessment that these conditions cannot be assumed to be met. This is due, in particular, to the fact that insolvency proceedings cannot be considered credible as a resolution tool for SIFIs, cf. below on the consequences of using the insolvency model of mortgage credit legislation.

At the same time, it is highly doubtful whether the authorities can realistically resolve a bridge institution or use divestment in the resolution of a mortgage bank, since the institutions are too big for national buyers, and since the business area is presumably too limited for foreign firms to find them interesting.

The issue of whether it is possible to resolve mortgage banks as part of an SPE resolution strategy is not considered in Danish legislation. It contains solely a general reference to the resolution authority's option of choosing either a multiple point of entry, MPE, resolution strategy or an SPE resolution strategy.⁹ The European Commission's proposal to amend the BRRD¹⁰, known as the BRRD2, makes it clear, however, that institutions that meet the conditions for being exempt from the MREL cannot be included in the general consolidated MREL set for the group.¹¹

Against that backdrop, the Danish resolution authorities must be considered to be prevented from choosing a resolution strategy whereby a mortgage bank is to be recapitalised using bail-in, restructured and continued.

Consequences of using the insolvency model

Insolvency proceedings for mortgage banks are deemed to entail considerable negative consequences for the economy and financial stability due to a number of factors:

- New loans will have to be granted by other institutions, as the institution loses its licence to operate as a mortgage bank under insolvency proceedings. This will generate capacity pressure in view of the institutions' market shares.

5 In Asbjørn Klein and Jakob Malte Svanborg, Too-big-to-fail can be solved inexpensively, *Danmarks Nationalbank Analysis*, No. 1, 2017, Danmarks Nationalbank made an analysis of the costs for mortgage banks associated with abolishing the exemption from bail-in and MREL.

6 Cf. section 24(4) of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.

7 Cf. section 266(1) of the Danish Financial Business Act with related explanatory notes and the explanatory notes for section 24(4) of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.

8 Cf. Article 45(3) of the BRRD.

9 Cf. in particular the explanatory notes to section 266(3) of the Danish Financial Business Act.

10 Cf. Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directives 98/26/EC, 2012/30/EU, 2011/35/EU, 2005/56/EC, 2004/25/EC and 2007/36/EC, BRRD2.

11 Cf. Article 45a(2) of the BRRD2. The provision reflects the assumptions of the exemption that mortgage banks can only be exempted from an MREL when they will be resolved in accordance with national insolvency procedures and the other BRRD tools, but without the use of bail-in.

- The bonds issued will lose their SDO status, unless the administrator injects the necessary top-up collateral to the relevant capital centres, which may be considered very difficult, as it is deemed very difficult to finance, given the risk. Similarly, the credit ratings of the institution and its bonds should be expected to deteriorate. As a consequence, the institution's (financial) creditors will need to hold more capital to cover the risks associated with the bonds, and it may mean that the bonds cannot be used for liquidity management purposes to the same extent.
- The final valuation of the mortgage bank's capital centres and the total estate may entail that the nominal claims of the creditors, including those of mortgage bond holders, are not (fully) paid and may be delayed.
- At the same time, there will be a particular effect on bonds with shorter remaining maturities, because the total value of the capital centre in question is not known until after expiry of the bonds with the longest maturities. Holders of bonds with shorter maturities thus run the risk of a temporary haircut until the final value of the capital centre is known, which may take up to 30 years.
- Given the insolvent institution's limited access to issue refinancing bonds, it must be assumed that the maturities of the bonds issued will be extended – with the resulting consequences for borrowers, investors and the real economy. It will become more difficult for borrowers to honour their obligations, implying further deterioration of the credit quality for investors.
- Borrowers' access to redeem the loans should be expected to entail that the most secure loans vanish from the balance sheet. This could give rise to a negative spiral between the market value of the institution's bonds and the average credit quality. The market value of the institution's bonds can thus be affected quickly, which will reinforce the negative pass-through to the institution's creditors, including the rest of the sector.

The application of the special insolvency model for mortgage banks may thus also have considerable

consequences for solvency and liquidity in the rest of the financial system, general confidence in mortgage bonds and hence the remaining mortgage banks' access to funding and thus their access to credit. As a result, it will not be credible to use an MPE resolution strategy for a mortgage bank by which the mortgage bank is separated from the rest of the group and liquidated.

In practice, it would be difficult to implement an MPE resolution strategy for mortgage banks due to the integrated structure of the groups. An MPE resolution strategy would entail the precondition that mortgage bank entities can be resolved and run as independent entities, including that it must be ensured in advance that mortgage banks can be separated, business-wise and operationally, from the rest of the group. Under such a strategy, therefore, it would probably be necessary for the Danish Financial Supervisory Authority to issue orders to the effect that such impediments to resolution must be removed. Such orders would be highly intrusive and burdensome for the groups.

In Danmarks Nationalbank's assessment, it is necessary to abolish the special Danish provisions exempting mortgage banks from MREL and bail-in. It is impossible to prepare credible resolution plans, which ensure financial stability, for groups with mortgage banks as long as this exemption applies. If the exemption of mortgage banks is abolished, the bail-in instrument could be used for mortgage banks; MREL could be set to support the tool in a resolution; and an SPE resolution strategy could be used to recapitalise the whole group so that it can continue.

General MREL principles

The MREL consists of two elements; 1. a *loss absorption amount* and 2. a *recapitalisation amount* in accordance with the Commission Delegated Regulation on the framework for setting the MREL¹². As a main

12 Cf. Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities (Articles 1 and 2 of the Delegated Regulation).

rule, the loss absorption amount corresponds to the total capital requirement including capital buffer requirements, while the recapitalisation amount corresponds to the total capital requirement. Danmarks Nationalbank generally supports an approach to setting the MREL for SIFIs in conformity with the EU.

The Regulation allows the national authorities to grant deductions or add-ons relative to this rule, depending on the conditions for the specific institution/group.¹³ In cases where it may become necessary to exempt certain creditors from bail-in of their claims with a view to financial stability, the MREL should be set at a sufficiently high level to ensure that funds from the Resolution Fund can be used as a supplement.¹⁴ This is, however, based on, inter alia, the condition that the authorities are not prevented from using the bail-in tool. In such case the backstop for resolution will be the Resolution Fund rather than insolvency proceedings.

In Danmarks Nationalbank's opinion caution should be exercised when granting deductions, as a sufficiently high MREL is crucial to ensure credible resolution plans. In some cases, this may be justified, however. For example, it should always be possible to set the countercyclical capital buffer at zero in the recapitalisation amount for SIFIs, and it may be considered whether it will be necessary to include the effect of the so-called output floors, which are under consideration by the Basel Committee, in the loss absorption amount.

Danmarks Nationalbank finds it important that the methodology for setting MRELs for the SIFIs meets the following conditions.

- *The MREL takes the risks in the individual groups into account.* If not, the MREL may be set too low for some groups. Thus the MREL may not be capped. That would imply that the MREL would be too low when the group's risks increase. Too low MRELs will undermine the practicability and credibility of the resolution plans.
- *The MREL is robust to a group's internal financial structure adjustments.* Accordingly, the total requirement for a group should not depend on the origins of its exposure. There should thus be no incentive to adjust intergroup exposures in order to achieve a reduced MREL (i.e. an incentive for regulatory arbitrage). This would entail a risk that the MREL becomes too low to meet the need for both loss absorption and recapitalisation of the group.
- *Setting of MRELs is competition-neutral in terms of both the relationship between banks and mortgage banks and the relationship between Danish and foreign institutions.* The MREL to cover loans of the same nature which are to be treated equally in a resolution must be the same whether the loans are granted by a bank or a mortgage bank.

Recommendation for handling failing SIFI groups

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¹³ Cf. Article 1(5)(b) and Article 2(7) and (8) of the Delegated Regulation.

¹⁴ Cf. Article 5(1) of the Delegated Regulation, Article 44(5) of the BRRD and section 59 of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises with related explanatory notes.

ABOUT ANALYSIS



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