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MREL for mortgage credit institutions: necessary and inexpensive

An MREL for mortgage credit institutions is necessary

A risk-sensitive MREL for mortgage credit institutions is necessary in order to ensure that there are sufficient funds to resolve them in a crisis situation.

The 8 per cent minimum requirement is not enough

Despite the introduction of a minimum requirement of 8 per cent of total liabilities and own funds, the requirements for some SIFIs remain too low to enable recapitalisation and continuation in a crisis situation.

The price is low: less than 1 basis point on average

The cost of introducing an MREL for mortgage credit institutions is equivalent to an average increase of 1 basis point in administration margins.

An MREL for mortgage credit institutions is necessary

Danish mortgage credit institutions are currently exempted from a minimum requirement for own funds and eligible liabilities, MREL, cf. Box 1. Instead, they must meet a debt buffer requirement, which generally constitutes 2 per cent of the mortgage credit institution's unweighted lending. Furthermore, in May 2018 a legislative amendment was passed which applies to SIFIs that are or include a mortgage credit institution.[1] The new legislation entails that the sum of the MREL for the group's bank and the capital and debt buffer requirements for the group's mortgage credit institution must constitute at least 8 per cent of total liabilities and own funds.[2] The debt buffer requirement must be increased if this is necessary in order to meet the 8 per cent requirement.

Despite the legislative amendment, the requirements for some SIFIs remain insufficient to enable recapitalisation and continuation of the entire group in accordance with the resolution strategy chosen. For that purpose, the requirement would have to be equivalent to twice the capital requirements, cf. Box 1. For other SIFIs, the amendment means that their requirements are sufficient in the current situation, but this could change. The reason is that the debt buffer requirement and the 8 per cent minimum requirement are not risk-sensitive. So the authorities may find that the requirements are too low in crisis times, when the institutions' risks, and hence their capital requirements, typically increase. And despite the amendment, it is still not possible to supplement with funds from the Resolution Fund when resolving a mortgage credit institution, even though the requirement constitutes 8 per cent of total liabilities and own funds.[3]

Consequently, Danmarks Nationalbank still recommends that the exemption of mortgage credit institutions from meeting an MREL be abolished.

1 SIFIs are systemically important financial institutions. In Denmark, there are five SIFIs that are or include a mortgage credit institution: Danske Bank, Jyske Bank, Nykredit Realkredit, Nordea Kredit and DLR Kredit.

2 Cf. section 125i of the Danish Financial Business Act.

3 Cf. Danmarks Nationalbank, Consultation response concerning the bill to amend the Danish Financial Business Act, Anti-Money Laundering Act, Act on Alternative Investment Fund Managers, etc. and various other acts (part III), dated 19 February 2018, English version published 24 May 2018 (*link*).

Purpose of the MREL and how it is set

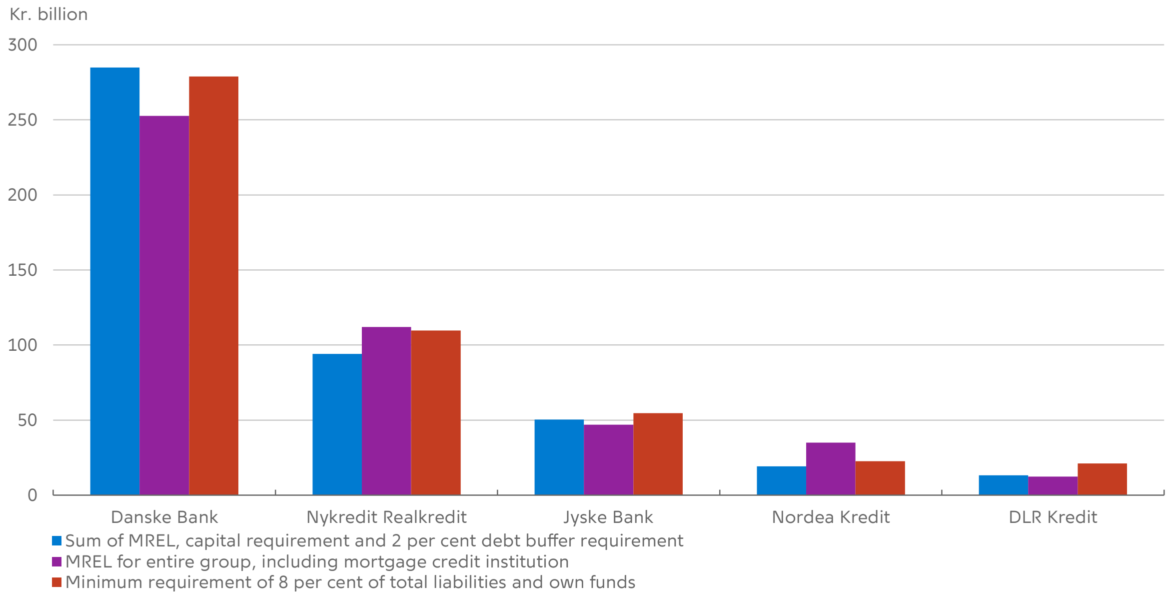
Box 1

The financial crisis showed that governments had to rescue failing credit institutions by using taxpayer funds to limit the negative implications for society. To avoid a similar situation in the future, the EU Bank Recovery and Resolution Directive, BRRD, was adopted in 2014. A key element of the Directive was the introduction of an MREL. This is to ensure that the institutions have sufficient capital and debt instruments that can be written down and converted in a crisis situation with a view to absorbing the institution's losses and recapitalising it if that is the resolution strategy. In that way, it is ensured that investors and creditors, rather than taxpayers, bear the costs of handling a failing credit institution. When the BRRD was implemented in Denmark, it was decided to exempt the mortgage credit institutions from bail-in and MREL. The concept of bail-in means that senior and subordinated liabilities are written down or converted to shares or other equity in order to absorb losses and/or recapitalise a failing credit institution.

An MREL consists of a loss-absorption amount and a recapitalisation amount that reflect the chosen resolution strategy for the individual group. During 2018 the Danish Financial Supervisory Authority has published the MREL for all SIFIs for which an MREL has to be set.[1] For SIFIs, the resolution strategy is to restructure the institution and return it to the market with sufficient capital to ensure market confidence. In order to be able to implement that strategy, the Danish Financial Supervisory Authority sets the MREL for SIFI banks at twice the capital requirement, i.e. twice the capital need and the combined capital buffer requirement. As mortgage credit institutions are exempted from MREL they are not included in the consolidation when setting MREL for groups that include both banks and mortgage credit institutions.[2]

1. See Danish Financial Supervisory Authority, Final resolution plans and MREL for systemically important banks, *Press release,* 28 March 2018 (*link*), and Danish Financial Supervisory Authority, Endelige afviklingsplaner for Nykredit og DLR og NEP-krav for Nykredit, *Press release,* 31 October 2018 (in Danish only) (*link*).
2. Cf. Danish Financial Supervisory Authority, Fact-sheet on the minimum requirements for own funds and eligible liabilities (MREL) for systemically important banks, 23 March 2018 (*link*).

Comparison of requirements for SIFIs with mortgage credit institutions Chart 1



Note: The larger of the blue and violet bars is the binding requirement for SIFIs under the current legislation, while the larger of the red and violet bars will be the binding requirement if an MREL is introduced for mortgage credit institutions. The requirements have been calculated on the basis of data at end-2016, which is the data on which the Danish Financial Supervisory Authority's decisions on MRELs for Danske Bank and Jyske Bank have been based. The fully phased-in requirements have been applied when calculating the MRELs and debt buffer requirements. The countercyclical capital buffer has been set at 1 per cent. For Nordea Kredit, an internal MREL will apply as Nordea Kredit is a subsidiary. The method for setting the internal MREL has not yet been determined but is expected to be specified in the amendment directive BRRD2.

Source: Danish Financial Supervisory Authority, financial statements and own calculations.

The costs of introducing an MREL for mortgage credit institutions are negligible

Danmarks Nationalbank's calculations show that the introduction of an MREL for mortgage credit institutions will *not* increase requirements for Danske Bank, Nykredit Realkredit and Nordea Kredit compared to the fully phased-in requirements applying to these institutions under current legislation, cf. Chart 1. However, it will lead to an increase in the requirements for Jyske Bank and DLR Kredit. It is assumed that the institutions will issue eligible liabilities equivalent to the increase in the requirement if an MREL is introduced for mortgage credit institutions. This will involve costs for the institutions corresponding to the spread between the rate of interest on the liabilities issued and the assets that the funds are invested in. The institutions can finance this by e.g. reducing costs or dividend payments or raising administration margins. In the analysis, a calculation is made of the price of introducing an MREL for mortgage credit institutions if they choose to cover the costs via higher administration margins.

Overall, the SIFIs will have to issue eligible liabilities for kr. 12 billion if an MREL is introduced for mortgage credit institutions. The associated costs are estimated at around kr. 180 million. When distributed on total lending by mortgage credit institutions, which was approximately kr. 2,700 billion at end-2016, this corresponds to an average increase in administration margins of 0.007 percentage point, i.e. less than 1 basis point. In comparison, the average administration margin for households is currently 91 basis points.[4]

The calculations are based on the SIFIs issuing non-preferred senior debt with a maturity of 5 years in order to meet the MREL and investing the funds in 5-year government bonds.[5] Over the last year, the SIFIs have issued non-preferred senior debt with a view to meeting their MRELs. Consequently, it is assumed that they will also opt for non-preferred senior debt if an MREL is introduced for mortgage credit institutions. The calculations are based on the following yields to maturity, which applied on 20 November 2018:

- 5-year non-preferred senior debt: 1.33 per cent. The yield has been estimated on the basis of the credit spread for the institutions' issuances and a 5-year DKK mid-swap rate of 0.46 per cent. The credit spread is a weighted average of the institutions' issuance need.
- 5-year government bonds: -0.17 per cent.

The MREL is calculated as twice the capital need and the combined capital buffer requirement.[6] It is assumed that a minimum requirement of 8 per cent of total liabilities and own funds will still apply to SIFIs even if an MREL is introduced for mortgage credit institutions. This is a relevant minimum requirement as it is a precondition that at least 8 per cent of total liabilities and own funds have already been written down or converted if the Resolution Fund is to contribute to loss absorption and recapitalisation.

Both the 8 per cent minimum requirement and an MREL for mortgage credit institutions will increase the requirements for mortgage credit institutions. As a result, the funding needs will increase in normal times but *not* in crisis times – on the contrary.[7]

4 As at September 2018. Source: Danmarks Nationalbank's Statbank (*link*).

5 The Danish Financial Supervisory Authority requires that the MRELs of the institutions must be met using capital and debt instruments that bear losses before senior unsecured creditors in connection with resolution and insolvency, also known as the subordination requirement. Non-preferred senior debt is a new layer in the creditor hierarchy that meets the subordination requirement.

6 The amendment directive BRRD2, which is currently being negotiated, is expected to introduce a requirement whereby the countercyclical capital buffer is to be excluded from the MREL recapitalisation amount.

7 Cf. Danmarks Nationalbank, MREL for mortgage banks reduces funding needs in times of crisis, *Danmarks Nationalbank Analysis*, No. 11, August 2018 (*link*).

ABOUT ANALYSIS

As a consequence of Danmarks Nationalbank's role in society we conduct analyses of economic and financial conditions.

Analyses are published continuously and include e.g. assessments of the current cyclical position and the financial stability.

The analysis consists of a Danish and an English version. In case of doubt regarding the correctness of the translation the Danish version is considered to be binding.

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