DANMARKS NATIONALBANK

To the Danish Financial Supervisory Authority
Attn.: Benjamin Juul Johansen

By email: hoeringer@ftnet.dk; bjj@ftnet.dk

**BOARD OF GOVERNORS**
Havnegade 5
1093 Copenhagen K
Tel.: +45 3363 6363

www.nationalbanken.dk
nationalbanken@nationalbanken.dk

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**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)**

A key lesson learned from the financial crisis is that it must be possible to address the problems of banks and mortgage banks without the use of government funds. The large, systemically important institutions perform functions that are critical to society and essential to financial stability. It must be possible to continue these functions if problems arise. This means that there must be sufficient funds contributed by owners and creditors, i.e. own funds and eligible liabilities.

If enacted, the bill will enable the Danish Financial Supervisory Authority to set a minimum requirement of 8 per cent of total liabilities and own funds for loss absorption and recapitalisation for systemically important groups that include a mortgage bank and for systemically important mortgage banks.

Danmarks Nationalbank supports that the bill is based on the premise that the resolution strategy for systemically important mortgage banks should be recapitalisation and continuation, as winding-up/liquidation would not be in the interest of the general public.

However, Danmarks Nationalbank has a number of specific comments on the proposed legislative amendments, which can be summarised as follows:

- The bill will not always allow the Danish Financial Supervisory Authority to support the preferred resolution strategy by setting an adequate requirement for own funds and eligible liabilities as the requirement is not risk-sensitive.
- There is no foundation for maintaining a non-risk-based approach to the recapitalisation of mortgage banks given the general Danish view that regulation of the capital of financial enterprises should be risk-based.

- Tax-financed intervention, bail-out, in relation to a distressed mortgage bank will still be a potential outcome in a crisis situation if sufficient requirements cannot be set for own funds and eligible liabilities and credible resolution plans prepared.
- The proposed legislative amendment does not make it clear which requirements can be imposed on systemically important mortgage banks that belong to foreign groups.

Danmarks Nationalbank acknowledges that in the current situation the bill makes it possible to set requirements for own funds and eligible liabilities that are sufficient to support a resolution strategy based on recapitalisation and continuation of SIFI mortgage banks and SIFI groups. But if the risks of SIFI mortgage banks increase, the authorities risk a shortfall of funds and it will not be possible to raise the requirement for own funds and eligible liabilities without amending the legislation again.

Consequently, Danmarks Nationalbank still recommends that the Danish exemption of mortgage banks from meeting a MREL be abolished. For this reason, we also find it positive that the bill includes a provision to evaluate the special Danish rules by 2021 at the latest.

**The bill's section 1, no. 3 – mortgage banks are to be comprised by an aggregate minimum requirement for liabilities for loss absorption and recapitalisation**

*The Danish Financial Supervisory Authority's determination of the minimum requirement*

The bill envisages an aggregate minimum requirement for the debt buffer, own funds and eligible liabilities of SIFI groups and SIFI mortgage banks, to be set at 8 per cent of total liabilities and own funds. This will mean that the applicable debt buffer may be adjusted upwards if necessary in order to meet an 8 per cent minimum requirement. As Danmarks Nationalbank reads the bill, the debt buffer add-on will only make it possible to raise the sum of the debt buffer, own funds and eligible liabilities to a maximum of 8 per cent. Thus it will not allow the debt buffer to reflect the actual risks of SIFI mortgage banks and SIFI groups.

Maintaining a non-risk-based approach to the recapitalisation of mortgage banks is contrary to the development in risk management over many years and contrary to the Danish approach to financial regulation[1] that is presented in international forums. This provides incentives to increase risk-taking, thereby also increasing the risk that the government

1 See e.g. the reports from the expert group on a minimum leverage ratio requirement for credit institutions and on the impact of the Basel Committee's recommendations on capital requirements for credit institutions.

may have to step in and provide guarantees for the mortgage banks in a situation where the economy is already under pressure.

The consequence of the bill would be that the requirement for mortgage banks would not be sufficiently sensitive to developments in the institutions' risk. Hence the requirement will be too low at times when the mortgage banks' risks are high. Therefore, it will not always be possible to draw up credible resolution plans for mortgage banks or mixed groups.

In Danmarks Nationalbank's opinion, the Danish approach to regulation of financial enterprises applied so far, i.e. that the requirement for a specific institution should reflect its risk, should be maintained. A risk-based requirement would mean that mortgage banks, which generally provide very secure loans, must meet a lower requirement than banks, whose loans are not equally secure. At the same time, a risk-based requirement would increase if the institution assumed further risk. In this way, a risk-based requirement would give institutions an incentive for sound risk management, as well as supporting an objective of uniformity among enterprises, irrespective of their organisation.

It appears from the bill that the MRELs set by the European resolution authority, the SRB, for the large groups in the banking union are generally of a size corresponding to 8 per cent of the group's total liabilities and own funds. However, the bill does not mention how the SRB sets MRELs.

It appears from the SRB's policies for setting MRELs that the point of departure is the European Commission's Delegated Regulation on MREL, 2016/1450. Accordingly, the MREL should, as a main rule, be set on the basis of the institution's risk-weighted assets as twice the total capital requirements, including solvency need and regulatory capital buffers. In addition, it is possible to determine institution-specific premia or deductions.

The SRB also states that it takes into account the harmonised resolution provisions, which specify that resolution options for a SIFI must not depend on public financial support. With a risk-based MREL that has been set at minimum 8 per cent of the liabilities, the SRB sets a level that is sufficiently prudent to have access to funds from the Resolution Fund for loss absorption/recapitalisation of a distressed institution. So it appears from the harmonised resolution rules that when the losses cannot be passed on to other creditors, the Resolution Fund can make contributions for loss absorption and recapitalisation of the institution being resolved. However, a number of strict conditions must be observed, includ-

ing that losses amounting to at least 8 per cent of total liabilities and own funds have already been subject to write down/conversion and the bail-in resolution tool. The consequence of the special Danish exemption of mortgage banks from MREL and bail-in is that the authorities cannot use the Resolution Fund as a backstop for mortgage banks.

The proposed Danish approach to setting requirements for own funds and eligible liabilities for SIFI mortgage banks and SIFI groups that include mortgage banks differs from the European approach in that it is not based on the institution's risk. At the same time, the special Danish regulation does not allow use of the Resolution Fund to exempt mortgage bonds from losses, even though the proposed requirement amounts to 8 per cent of liabilities. This is due to the regulatory requirement that the bail-in resolution tool must be applied before the Resolution Fund can be used.

*Interaction with the Bank Recovery and Resolution Directive and requirements for cross-border groups*
The proposed amendments will implement rules for national SIFIs only. This presents a challenge in relation to Danish SIFI mortgage banks that are part of cross-border groups.

Hence, the bill does not consider whether e.g. Nordea Kredit must observe a minimum requirement of 8 per cent at the consolidated level (cf. section 125i (2), first sentence, of the bill) or at the individual level (cf. section 125i (2), second sentence, of the bill). As Danmarks Nationalbank sees the existing Danish exemption of mortgage banks from MREL and bail-in, the exemption prevents the Danish Financial Supervisory Authority from setting an internal MREL for Nordea Kredit for possibly supporting a resolution strategy to continue the whole Nordea Group where the group resolution authority sets a consolidated MREL for the Nordea Group, including Nordea Kredit.

The Nordea Group has been designated as a global SIFI under international regulation and has a Swedish parent company. This means that the resolution authority is located in Sweden (and with the move to Finland it will be the European resolution authority). In this case, the special Danish provisions applying to Danish SIFI mortgage banks will cross the European rules applied by the group resolution authority in Sweden when setting the MREL for the group. Since only Nordea Kredit has been designated as a national SIFI, while the group has been designated as a global SIFI governed by the home country's group resolution authority and regulation, it is uncertain whether the proposed legislation will entail that Nordea Kredit must observe a special Danish minimum requirement of 8

per cent at the individual level or whether the minimum requirement is to be met at the consolidated level.

The bill does not consider the principles to be applied by the Danish Financial Supervisory Authority when setting the minimum requirement for a Danish subsidiary of a foreign group such as the Nordea Group, which already has to observe a consolidated MREL, including the mortgage bank, under the European rules.

Danmarks Nationalbank would like to see a bill that takes into account the interaction between the special Danish MREL rules for mortgage banks and the provisions of the Bank Recovery and Resolution Directive on cross-border groups. At the same time, it is noted that this issue would be eliminated if the Danish exemption were abolished.

**The bill's section 1, no. 8 – mortgage banks are exempted from a consolidated MREL**

The bill seems to implement part of the Directive to amend the Bank Recovery and Resolution Directive currently being negotiated in the EU, cf. Article 45a(2) of the amending Directive. However, it does so without considering whether the conditions for implementing that part of the Directive are in place after a possible adoption of the amending Directive, cf. Article 45a(1).

Instead of waiting until the amending Directive is to be implemented before assessing whether the conditions for maintaining the exemption from MREL and bail-in have been met, Danmarks Nationalbank suggests that the bill should consider this now.

As the aim of the bill is to support a recapitalisation and continuation strategy for mortgage banks and groups that include mortgage banks, it is difficult to understand the rationale for exempting mortgage banks that are part of a group from a consolidated MREL.

From the deliberations of the Ministry of Industry, Business and Financial Affairs on the proposed amendment to section 266 it is seen that the rationale is that the existing exemption of mortgage banks from the MREL would otherwise be circumvented and that the bill is in accordance with the Directive to amend the Bank Recovery and Resolution Directive currently being negotiated by the European Commission.

Danmarks Nationalbank would like to point out that the forthcoming amendments to the Bank Recovery and Resolution Directive explicitly state that only mortgage banks that, inter alia, meet the requirement for

being liquidated in a resolution situation, can be exempted from consolidation.

**The bill's section 1, no. 9 – mortgage banks may issue MREL liabilities**
Finally, the bill envisages that mortgage banks forming part of a group should be able to issue the liabilities to be used for meeting the group's MREL. It is inconsistent that precisely the mortgage bank, which is exempt from the MREL, could issue the MREL liabilities of the group. Furthermore, Danmarks Nationalbank notes that the contractual provisions that are to enable write down and conversion of the instruments are not elaborated on in the bill.

Yours sincerely,

Lars Rohde