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CONSULTATION RESPONSE CONCERNING THE BILL TO AMEND THE DANISH FINANCIAL BUSINESS ACT ETC.

On 30 June 2020, the Danish Financial Supervisory Authority submitted for consultation a bill to amend the Danish Financial Business Act (*Lov om finansiel virksomhed*), the Danish Act on Restructuring and Resolution of Certain Financial Undertakings (*Lov om restrukturering og afvikling af visse finansielle virksomheder*) and the Danish Capital Markets Act (*Lov om kapitalmarkeder*) and repeal the Danish Financial Stability Act (*Lov om finansiel stabilitet*). The bill primarily implements amendments resulting from revisions to the Capital Requirements Directive (CRD V) and the Bank Recovery and Resolution Directive (BRRD II).

Danmarks Nationalbank welcomes the bill's general approach to implementing the outcomes required by the directives. It is important to have a 'level playing field' between credit institutions in Denmark and other EU member states.

However, the bill continues the special Danish rules preventing the authorities from resolving mortgage credit institutions in the same orderly way as systemic Danish banks.

Mortgage bonds have a critical function in real estate financing. In addition, mortgage bonds represent a significant proportion of credit institutions' liquidity positions. Consequently, it is a concern for Danmarks Nationalbank that the resolution authorities may be forced to let mortgage bonds absorb losses in a resolution situation. This implies a risk of a general loss of confidence in Danish mortgage bonds and thus contagion to the rest of the sector, resulting in financial instability.

The special regulation of the mortgage credit sector

- leaves the authorities without the right tools for resolution of mortgage credit institutions;
- makes it impossible to protect mortgage bond holders from losses in all scenarios;
- may lead to separation of groups as well as bankruptcy proceedings or 'de facto bail-in' in mortgage credit institutions;
- has only government and taxpayer resources as a backstop for resolution of mortgage credit institutions;
- entails that the debt buffer requirement is not risk sensitive.

Consequently, under the current legislation, it will not always be possible for resolution authorities to draw up credible and feasible resolution plans for mortgage credit institutions and groups including mortgage credit institutions.

Danmarks Nationalbank therefore recommends repealing the Danish special regulation for resolution of mortgage credit institutions. This will also make it possible to use the Resolution Fund as a backstop for mortgage credit institutions. This will reduce the risk of mortgage bonds being exposed to 'de facto bail-in'.

Danmarks Nationalbank welcomes the implementation of the O-SII buffer under the CRD V. Given that, in future, the O-SII buffer will be used to determine the SIFI buffer, Danmarks Nationalbank encourages revisiting the Danish methodology for SIFI designation, as the criteria for the current Danish SIFI designation methodology were introduced before EU criteria were established.

In addition, Danmarks Nationalbank calls for the Systemic Risk Council to be consulted prior to the decision of the Minister for Industry, Business and Financial Affairs on whether a systemic risk buffer rate recognised in another country and a Danish systemic risk buffer rate mitigate different risks. Finally, the bill should clarify the role of the Systemic Risk Council in determining the capital buffers.

Danmarks Nationalbank's consultation response is described in more detail in Appendices 1 and 2.

Yours sincerely,

Lars Rohde

Appendix 1: General comments on the bill

The bill maintains the legislation preventing the authorities from applying the bail-in resolution tool to mortgage credit institutions' creditors, and exempting mortgage credit institutions from the minimum requirement for own funds and eligible liabilities. Instead, mortgage credit institutions must continue to meet a special Danish debt buffer requirement.

As opposed to the non-subordinated creditors of systemic banks, the special regulation for mortgage credit institutions makes it impossible for the authorities to keep the non-subordinated creditors of mortgage credit institutions free from losses, also in the case of any unsecured part of a mortgage bond that may be left in a bankruptcy estate and thus subject to 'de facto bail-in'.

Mortgage bonds have a critical function in the financing of real estate and represent a significant part of the liquidity positions of credit institutions. Through bankruptcy and 'de facto bail-in', mortgage bonds can absorb losses. This implies a risk of a general loss of confidence in Danish mortgage bonds and thus contagion to the rest of the sector, resulting in financial instability.

The problem is that it is not possible to let the Resolution Fund, instead of the creditors, absorb losses in a mortgage credit institution – despite the debt buffer requirement ensuring that at least 8 per cent of the liabilities are eligible liabilities. Consequently, unlike banks, mortgage credit institutions have no loss-absorbing backstop. This implies that the resolution authorities are ultimately left with bankruptcy and 'de facto bail-in' on the mortgage institution's creditors through the use of the bridge institution resolution tool. These resolution models are not sustainable for mortgage credit institutions, which should be treated as SIFI banks in order to ensure credibility of the resolution plans and not create unnecessary instability in a resolution situation.

Under current legislation, the only alternative is to allow the state to step in. A key lesson from the financial crisis was that crises in the financial sector should not be addressed by means of government resources. In addition, Danmarks Nationalbank considers that the special regulation of mortgage credit institutions makes the legislation unnecessarily complicated because mortgage credit institutions are part of different corporate structures and the special regulation must take each structure into account.

Danmarks Nationalbank believes that the conditions for the Danish special regulation of mortgage credit institutions are not fulfilled. The Danish

special regulation entails the risk of the authorities having to split up groups in a resolution situation and resolve mortgage credit institutions separately – this also applies to cross-border groups.

For these reasons, Danmarks Nationalbank does not agree that, with the bill, the authorities are maintaining the exemption regarding mortgage credit institutions, which prevents the authorities from applying the bail-in resolution tool to mortgage credit institutions. We therefore recommend repealing the special resolution provisions for mortgage credit institutions and implementing the harmonised rules. This will allow the resolution authorities to also apply the bail-in resolution tool to mortgage credit institutions and ensure a risk-sensitive MREL for mortgage credit institutions to support the resolution strategy.

Finally, consideration should be given to evaluating the appropriateness of the current division of resolution authority competences between Finansiel Stabilitet and the Danish Financial Supervisory Authority. The resolution planning has now been underway for a number of years, making it appropriate to assess whether the shared resolution competence makes it more onerous to draw up resolution plans and make resolution decisions, and whether the division ensures optimal utilisation of the authorities' resources and competences. Danmarks Nationalbank still finds it essential that the division of the resolution competences between two authorities should not stand in the way of efficient resolution of a failing financial undertaking.

This is a large and complex bill, so it would be appropriate to continue to clarify and elaborate on the explanatory notes to the bill before submitting it, including the interaction between the proposed rules and the law already in force. This should also include clarification of and elaboration on the comments on the provisions on authorisation .

Appendix 2: Technical comments on the bill

Re the bill's section 1, no. 78 (sections 267 and 267 h of the Danish Financial Business Act) – determination of the MREL

For resolution groups, the MREL must be determined at consolidated level. According to the bill, as a result of the MREL exemption, mortgage credit institutions should not be included in the consolidation when setting the MREL for the group. Such an approach does not appear to be consistent with the established resolution strategy for the SIFI groups, which entails that the whole group – including mortgage credit institutions – should be recapitalised and continued. In addition, the bill should explain how the balance sheets of mortgage credit institutions should technically be excluded from the consolidation of the MREL for the group.

Moreover, since it appears from the bill that small and medium-sized institutions will also be subject to the MREL, it is important for the bill to address more extensively the handling of non-SIFIs that are failing or likely to fail and the determination of the MREL for them. Danmarks Nationalbank supports the orderly resolution of small and medium-sized institutions. However, such resolution does not require the institution to be recapitalised, and it is thus not necessary to set a recapitalisation amount greater than zero for those institutions. The resolution of small and medium-sized institutions does not require the same consideration of the economy and financial stability compared to resolution of SIFIs.

Re the bill's section 1, no. 78 (sections 267 b and 267 c of the Danish Financial Business Act) – subordination requirement for own funds and eligible liabilities

Danmarks Nationalbank acknowledges the benefits of a requirement to meet the MREL by means of capital instruments and debt liabilities that bear losses before simple claims in the event of resolution and bankruptcy, a so-called 'subordination requirement'. The subordination requirement helps to ensure transparency and a clear legal framework for which creditors should bear losses and what funds should be available for the recapitalisation of an institution in a resolution situation. In addition, a subordination requirement also makes it operationally easier for resolution authorities to manage the resolution of an institution.

For these reasons, Danmarks Nationalbank supports the bill's utilisation of the directive framework in setting requirements for banks to the effect that as many as possible of the capital instruments and debt liabilities required to meet the MREL should bear losses before simple claims in case of resolution or bankruptcy. Consequently, we also agree that the sub-

ordination requirement should be increased for more than 30 per cent of the largest and most systemically important institutions.

Among other things, the bill states as grounds for the decision not to limit the increase of the subordination requirement to 30 per cent of the largest and most systemically important institutions that the resolution strategy would otherwise be credible and feasible to a limited extent only. For the sake of good order, Danmarks Nationalbank notes that it should also be possible for resolution authorities to deal with write-down and conversion of non-subordinated eligible liabilities.

In general, the bill does not clearly refer to the various instruments' positions in the creditor hierarchy. The order in which the various instruments are to absorb losses must not be in doubt if an institution becomes failing or likely to fail. We therefore recommend that the bill should generally refer to the creditor hierarchy of the Danish Bankruptcy Act (*Konkursloven*) and the modifications in the Danish Act on Restructuring and Resolution when ranking the various instruments as regards loss absorption.

Re the bill's section 1, no. 78 (sections 268-268 e of the Danish Financial Business Act) – debt buffer requirements of mortgage credit institutions

It is apparent from the bill's explanatory notes that it proposes a requirement to meet the debt buffer requirement by means of capital instruments and debt liabilities that bear losses before simple claims in the event of resolution and bankruptcy, which is currently provided for in the guidance on liabilities to meet debt buffer requirements. As mentioned above, a subordination requirement has a number of advantages, so Danmarks Nationalbank supports a requirement that the instruments used to meet the debt buffer requirement bear losses before simple claims in the event of resolution and bankruptcy.

However, Danmarks Nationalbank finds that the actual legislative text is unclear as to whether the bill requires subordination of the debt buffer. It is apparent from the proposed section 268 a(2) that mortgage credit institutions which are resolution entities must meet the debt buffer requirement by means of own funds or subordinated eligible instruments, meaning a subordination requirement. At the same time, however, the proposed section 268 a(1), no. 4, states that a mortgage credit institution which is a resolution entity may meet the debt buffer requirement by means of unsecured senior debt. The explanatory notes on this provision further state that unsecured senior debt is 'neither subordinated nor preferred'.

This gives rise to repeating the above remark and recommendation that there must be no doubt as to the loss absorption order of the various instruments. Therefore, the bill should refer to relevant laws and regulations when ranking the various instruments as regards loss absorption.

Section 268 b of the bill does not require subordination of the debt buffer for mortgage credit institutions which are not resolution entities. However, the general explanatory notes to the bill state that the debt buffer requirement must be met by capital instruments and debt liabilities that bear losses before simple claims in the event of resolution and bankruptcy. We therefore propose to clarify in the bill that a subordination requirement for the debt buffer should also apply to mortgage credit subsidiaries which are not resolution entities.

The total requirement for a group involving a mortgage credit institution consists of the group's debt buffer requirement, own funds requirements for the group's mortgage credit institutions and the MREL. These requirements in total must be at least 8 per cent of the group's total liabilities and own funds. The explanatory notes on section 268 should clarify the specification of the overall requirement of a group including a mortgage credit institution. This includes, inter alia, the definition of 'own funds requirements for the group's mortgage credit institutions' and whether the own funds requirements in this context also include the leverage ratio requirement, which we assume.

Re the bill's section 1, nos. 44-47 (section 125 h(3) of the Danish Financial Business Act) – power of the Minister for Industry, Business and Financial Affairs to determine whether a systemic risk buffer rate recognised in another country and a Danish systemic risk buffer rate are cumulative

The bill gives the Minister for Industry, Business and Financial Affairs the power to decide whether a systemic risk buffer rate recognised in another country and a Danish systemic risk buffer rate mitigate different risks. If the buffer rates address different risks, the Minister for Industry, Business and Financial Affairs may decide whether the buffer rates are cumulative in determining their systemic risk buffer.

Danmarks Nationalbank calls for the Systemic Risk Council to be involved in the decision-making process, so that the Systemic Risk Council is consulted prior to the decision of the Minister for Industry, Business and Financial Affairs on whether a systemic risk buffer rate recognised in another country and a Danish systemic risk buffer rate mitigate different risks.

Re the bill's section 1, no. 50 (section 152(1) of the Danish Financial Business Act) – specific liquidity requirements for systemic liquidity risks

The bill no longer allows the Danish Financial Supervisory Authority to set specific liquidity requirements based on systemic liquidity risks. Going forward, specific liquidity requirements should be based on a firm-specific approach.

Danmarks Nationalbank considers it essential to emphasise in the explanatory notes to the bill that existing legislation and practices in this area can be maintained. It should also be stressed that the elimination of the possibility of setting specific liquidity requirements solely on the basis of systemic liquidity risks does not lead to easing of the existing liquidity requirements for Danish financial undertakings.