DANMARKS NATIONALBANK

4 MARCH 2021 — NO. 4

Crisis management of credit institutions – what is new?

Ready for crisis management - this time creditors will pay

Today, we have crisis management rules in Denmark and the rest of the EU which ensure crisis management of failing credit institutions without the use of government funds. Instead, the institution's own investors and creditors will pay for the crisis management. This is a completely different situation to that during the financial crisis.

Read more

More likely that senior unsecured creditors must contribute

The crisis management rules have recently been revised. The new rules make it more likely that senior unsecured creditors, for example large corporations, will have to contribute to the crisis management of a failing credit institution.

Read more

Senior unsecured creditors must be prepared

There is no special safeguard for senior unsecured creditors. It is important that they are aware of the increased risk of having to contribute to the crisis management, and that they take this into account in their risk management.

Read more

Crisis management of credit institutions – where are we today?

A lot has happened in relation to crisis management of credit institutions since the financial crisis. This analysis explains where we are today – and highlights areas of attention. The analysis focuses on the crisis management of the systemically important institutions, the so-called SIFIs.

A key lesson from the financial crisis was that neither liquidation nor government funds are a good way to manage failing credit institutions. A sensible alternative to these solutions was consequently lacking. Some credit institutions are so large and important to society that they cannot enter into liquidation proceedings without this having serious consequences for society. The reason for this is that these institutions perform critical functions which it is necessary to maintain to ensure that citizens in society can borrow money, save up, make payments etc. Therefore, the only way out during the financial crisis was for the institutions to be saved by the government – a so-called bail-out. A system had thus been created in which the financial sector landed the gain when things went well, while society and taxpayers were left holding the bill when things went wrong. This tie between government and financial sector had to be severed. In 2014, the EU therefore adopted a crisis management directive (Bank Recovery and Resolution Directive, BRRD). In May 2019, a number of amendments to the crisis management directive (BRRD2) were adopted. The implementation of the amendments entered into force in Denmark on 28 December 2020.

The crisis management directive ensures that the authorities have the necessary tools and powers for crisis management of failing credit institutions. In Denmark, such crisis management is handled by Finansiel Stabilitet (the Financial Stability Company) and the Danish Financial Supervisory Authority – the so-called resolution authorities.

The crisis management directive means that, instead of an institution either entering into liquidation proceedings or being bailed out by the government, the resolution authorities can now let the investors and creditors absorb the losses – a so-called bail-in – while the institution's critical functions are continued, so that the individual citizens can still conduct their banking transactions. The whole idea is that once the authorities have handled the crisis management of the institution, it can return to the market as a viable institution *after* investors and creditors have absorbed the losses that need to be incurred. This should all be dealt with during a single weekend to avoid significant disruptions to financial markets and society.

To ensure that such crisis management can be implemented in practice, the resolution authorities have been working to develop crisis management plans for the individual institutions since the introduction of the crisis management framework. Today, the authorities are thus far better equipped to handle a crisis in the financial sector than they were during the financial crisis.

The crisis management framework is still being developed and, as mentioned, a revised crisis management framework has recently entered into force in Denmark. It is important that both authorities and credit institutions continue to prepare for a crisis situation and improve the possibilities of rapid, flexible and controlled crisis management, so that negative impacts on financial stability and the real economy are avoided.

With the revised crisis management framework, a maximum limit has been introduced for the so-called subordination requirement. This means that there are limits to how large a share of the minimum requirement for owns funds and eligible liabilities (the MREL requirement) the authorities can demand must be met with subordinated liabilities[1]. The new maximum limit for the subordination requirement makes it more likely that senior unsecured creditors will have to contribute to the crisis management of a failing credit institution. Contributions may take the form of

1 A liability is subordinated if it bears losses before senior unsecured claims.

the liabilities covered by the creditors' claims being written down or being converted.[2] Senior unsecured creditors include large corporations with deposits of more than 100,000 euro. Senior unsecured creditors now also risk having to make contributions in situations that are regarded as normal loss scenarios from a crisis management perspective. Both the resolution authorities and the creditors of the institutions should be aware of and prepare to be able to handle this.

Where the resolution authorities perform a bail-in in a crisis situation, see Box 1, they may, in exceptional cases, exempt liabilities from the bail-in. It is important that the resolution authorities use such special bail-in exemptions sparingly as a tool for exempting some senior unsecured creditors from having to contribute to the crisis management. A liability should only be exempt from bail-in if there is a very weighty reason for this, for example consideration of financial stability. It is a cornerstone of the crisis management framework that the institution's investors and creditors must bear the losses. The principle should therefore only be deviated from when absolutely necessary.

Bail-in means write-down and conversion — Box 1

Bail-in is a crisis management tool (resolution tool) which enables the resolution authorities to write down the value of an institution's capital and liabilities in a situation with crisis management of the institution.[1] This means that the institution's losses can be absorbed. The bail-in tool also allows resolution authorities to convert an institution's debt into capital. This means that the institution can be recapitalised, so that it can again meet the capital requirements and be returned to the market as a viable institution after crisis management. The bail-in must be performed in accordance with the hierarchy of creditors, see Box 5. This means that the creditors who would get their money last in liquidation proceedings are the first to be exposed to a bail-in in a crisis situation.

1. Formally, it is not the bail-in tool that is used when capital instruments are written down or converted, but instead a separate power to write down and convert relevant capital instruments. However, this is collectively referred to as bail-in in the analysis.

Special crisis management rules apply to Danish mortgage credit institutions. These rules and their implications are not addressed in this analysis.

Creditors must foot the bill – not taxpayers

The crisis management framework has provided the resolution authorities with a number of extensive powers and tools. These are to enable the authorities to maintain the credit institutions' critical functions in a crisis situation, see the resolution goals in Box 2. The powers granted to the authorities include the power to take over the control of a failing institution, replace the management, demand that parts of an institution be sold and suspend contractual rights.

One of the most important tools that the authorities have been given is the bail-in tool, see Box 1. The bail-in tool allows the resolution authorities to write down and convert an institution's capital and debt in a crisis situation. This ensures that the institution's investors and creditors are those who foot the bill in connection with crisis management of the institution – not the taxpayers. This is a sound principle that helps ensure that the institutions have the right risk management incentives and do not take excessive risks because they expect to be bailed out by the government.

To ensure that the institutions do not compose their liabilities (capital and debts) in a way that means that the bail-in tool cannot be used or becomes less effective, the resolution authorities must lay down a so-called MREL requirement, see Box 3. The purpose of the MREL requirement is thus to ensure that the institutions have sufficient liabilities suitable for loss absorption and recapitalisation when facing a crisis management situation. The MREL requirement can be met with, for example, capital instruments, senior non-preferred debt and ordinary senior debt. For a liability to be used to meet the MREL requirement, it must, among other requirements, have a remaining maturity of minimum one year.

2 It is more likely that liabilities payable to senior unsecured creditors will be converted than that they will be written down.

Crisis management must ensure that resolution goals are met

Box 2

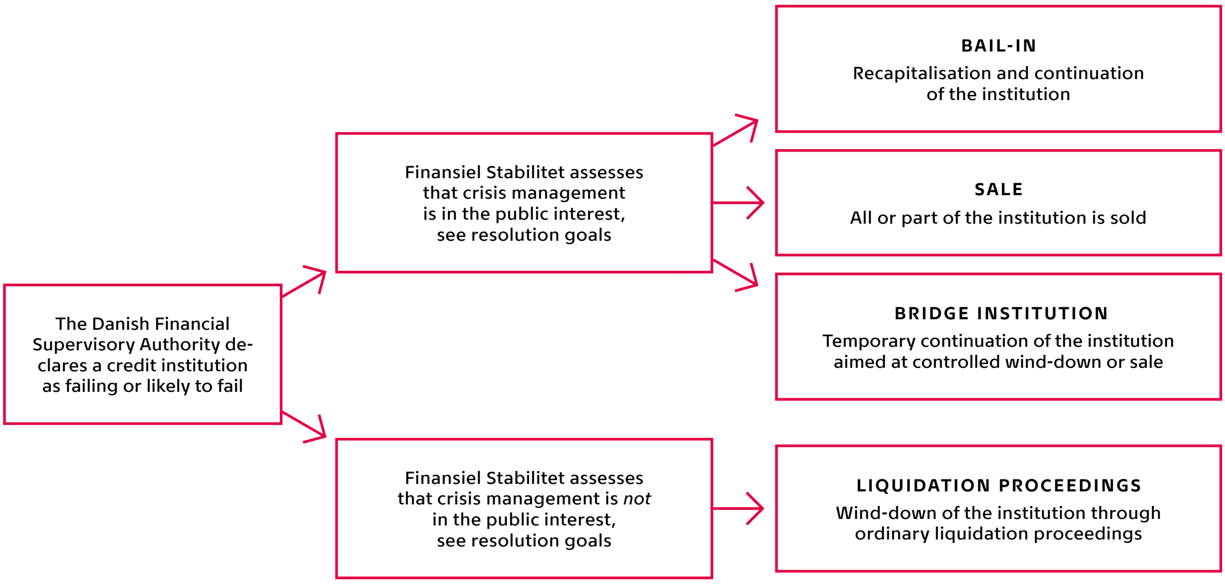
If the Danish Financial Supervisory Authority declares an institution as failing or likely to fail, for example if the institution fails to meet its capital requirements, Finansiel Stabilitet must decide whether crisis management of the institution is in the public interest. However, it must first be examined whether a private solution can be found. Crisis management will be in the public interest if it is necessary to meet one or more of the resolution goals laid down in the crisis management framework. The resolution goals are to:

- ensure the continuation of critical functions where discontinuation of such functions is expected to result in significant disruptions to the real economy or financial stability
- avoid significant negative impacts on financial stability by preventing contagion and maintaining market discipline
- protect public funds by minimising dependence on extraordinary public financial support
- protect depositors and investors covered by a deposit guarantee scheme
- protect customers' funds and assets.

For all Danish SIFIs, the crisis management strategy is that the whole group must be recapitalised and continued, so that the critical functions can be maintained.[1] This is done using the bail-in tool.

The general strategy for small and medium-sized institutions in Denmark is that Finansiel Stabilitet conducts a so-called orderly wind-down.[2] This means that as much of the activities as possible will be sold, while the remainder of the institution will be continued temporarily under the control of Finansiel Stabilitet. This is done using the sale of business tool and the bridge institution tool.

If crisis management is not found to be in the public interest, liquidation proceedings must be commenced for the institution.



1. See the Danish Financial Supervisory Authority, *Final resolution plans and MREL for systemically important banks*, 28 March 2018 (*link*).
2. See the Danish Financial Supervisory Authority, *Resolution strategy and MREL for small and medium-sized banks*, 20 November 2017 (*link*).

MREL requirement under BRRD2

Box 3

As part of the crisis management framework, credit institutions must meet a minimum requirement for own funds and eligible liabilities (MREL requirement). The purpose of an MREL requirement is to ensure that the institutions have sufficient capital instruments and debt liabilities that can be written down and converted in a crisis situation to absorb the institution's losses and recapitalise the institution. The MREL requirement entails that a specific proportion of the institutions' liabilities must consist of certain types of capital instruments and liabilities. BRRD2 has introduced a number of changes to the MREL requirement. Some of the changes are of a more technical nature and are therefore of no importance to the overall requirement for the institution.

Loss absorption amount and recapitalisation amount
The MREL requirement consists of a loss absorption amount and a recapitalisation amount, which must reflect the crisis management strategy for the individual institution. For the systemically important institutions, the SIFIs, the crisis management strategy is that the whole group must be recapitalised and continued. The loss absorption amount is the amount that the institution must, as a minimum, be able to tolerate losing, whereas the recapitalisation amount must ensure that the institution's capital can be restored to a level where the institution is once again in compliance with the capital requirements and can maintain sufficient market confidence. This is to ensure that the SIFI can be continued as a viable institution after crisis management.

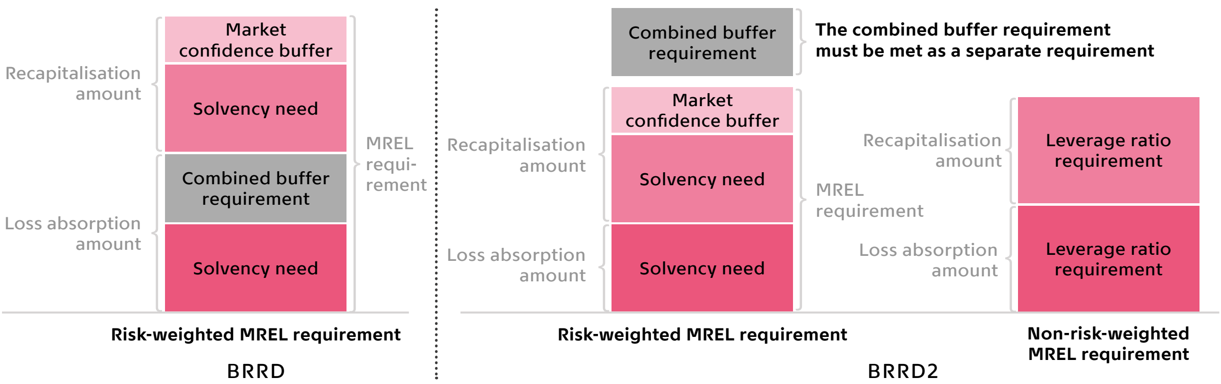
The loss absorption amount and recapitalisation amount of the MREL requirement must be set based on the capital requirements of the institutions. The capital requirements consist of the solvency need and the combined buffer requirement. For the SIFIs, three buffers are included in the combined buffer requirement today: the capital conservation buffer, the SIFI buffer and the countercyclical capital buffer. All these requirements are calculated on the basis of the institution's risk-weighted exposures. In parallel with the solvency need and the combined buffer requirement, the institutions must also meet a so-called leverage ratio requirement, which is calculated on the basis of the institution's non-risk-weighted exposures.

Two MREL requirements
BRRD2 entails that there are now two MREL requirements. In future, the MREL requirement must thus be set both as a percentage of risk-weighted exposures (the risk-weighted MREL requirement) and as a percentage of non-risk-weighted exposures (the non-risk-weighted MREL requirement). Until now, the institutions have only been obliged to meet a risk-weighted MREL requirement. The two MREL requirements reflect the capital requirements, which also comprise both a risk-weighted requirement and a non-risk-weighted requirement, see the above.

For the risk-weighted MREL requirement, the basis is that the loss absorption amount corresponds to the solvency need, while the recapitalisation amount corresponds to the solvency need plus a market confidence buffer. The market confidence buffer is calculated as the combined buffer requirement less the countercyclical capital buffer.

For the non-risk-weighted MREL requirement, the basis is that both the loss absorption amount and the recapitalisation amount must correspond to the leverage ratio requirement. The leverage ratio requirement is 3 per cent of non-risk-weighted exposures.

Combined buffer requirement must be met separately
With BRRD2, the combined buffer requirement will no longer be included in the loss absorption amount for the risk-weighted MREL requirement, which has previously been the case. Instead, it must be met as a separate requirement. The instruments used to meet the combined buffer requirement must not be used concurrently to meet the risk-weighted MREL requirement. The MREL requirement is consequently reduced, but, in return, the buffer requirement must be added to the MREL requirement. The overall requirement imposed on the institutions is thus unchanged. The amendment contributes to ensuring that the combined buffer requirement can function as intended, namely as a buffer.



1. See Danmarks Nationalbank, Resolution Strategy for Systemically Important Groups, *Danmarks Nationalbank Analysis*, no. 21, 20 November 2017 (*link*).

The resolution authorities must prepare institution-specific crisis management plans

Box 4

The crisis management framework means that the resolution authorities must prepare crisis management plans (resolution plans) for the individual institutions. The plans must assess whether it is credible to let the institution enter into liquidation proceedings, i.e. whether liquidation is a realistic and viable solution. If liquidation is found not to be a credible solution, the resolution authorities must establish a preferred crisis management strategy for the institution, which must also be described in the plan. The resolution authorities must ensure that the preferred crisis management strategy is credible and feasible. The legislation lists the elements that the plans must contain to ensure the credibility and feasibility of the strategy.

There are a wide range of elements that the resolution authorities must have examined and taken into account – in collaboration with the institutions – before the crisis management plans meet the statutory requirements. These include mapping the structure and organisation of the institutions and identifying critical functions. It must be ensured that operational services which support critical functions can be continued in a crisis situation, and that the institutions can maintain access to financial market infrastructures such as payment systems. The resolution authorities must also ensure that there is an overview of the institution's liquidity needs and sources in a crisis situation. In addition, both institutions and resolution authorities must have established a process for how a bail-in on the institution's liabilities is performed in practice. Both the preparation of the crisis management plans and the actual management of a potential crisis situation are based on the institutions being able to provide the necessary data. If the resolution authorities assess that there are impediments to the crisis management of an institution, the authorities have the powers to remove such impediments.

The resolution authorities must prepare crisis management plans for the individual institutions, see Box 4. The plan must lay down a preferred crisis management strategy for the institution, and it must be ensured that the strategy is credible and feasible. Feasibility is about the strategy being implementable in practice, while credibility is about the strategy not having significant negative impacts on financial stability or the real economy. The legislation lists the elements to be included in the assessment of the credibility and feasibility of the strategy.

For cross-border groups, a so-called resolution college is established. The college consists of authorities from the different countries in which the group carries on activities. The authorities represented in the college must jointly agree on the crisis management plan for the group. They must also ensure coordination across national borders in the event of a crisis situation. The financial markets in the EU are highly integrated, making it important that the authorities in the different EU countries collaborate on handling a crisis situation to avoid cross-border contagion. The Danish SIFIs Danske Bank and Nordea Kredit are or form part of a cross-border group.

Greater likelihood that senior unsecured creditors must contribute to crisis management

With BRRD2, it has become more likely that senior unsecured creditors will have to contribute to the crisis management of a failing credit institution. Both the resolution authorities and the creditors of the institutions should be aware of and prepare to be able to handle this. For senior unsecured creditors, this means that they should take this risk into account in their risk management.

The Danish Financial Supervisory Authority has so far required that Danish banks must meet their whole MREL requirement with subordinated liabilities, that is liabilities that bear losses before senior unsecured claims. Subordinated liabilities include capital instruments and senior non-preferred debt, see the hierarchy of creditors in Box 5. Senior unsecured claims are a class in the hierarchy of creditors which comprises all the liabilities that are not specifically covered by one of the other classes in the hierarchy of creditors. Therefore, senior unsecured claims comprise

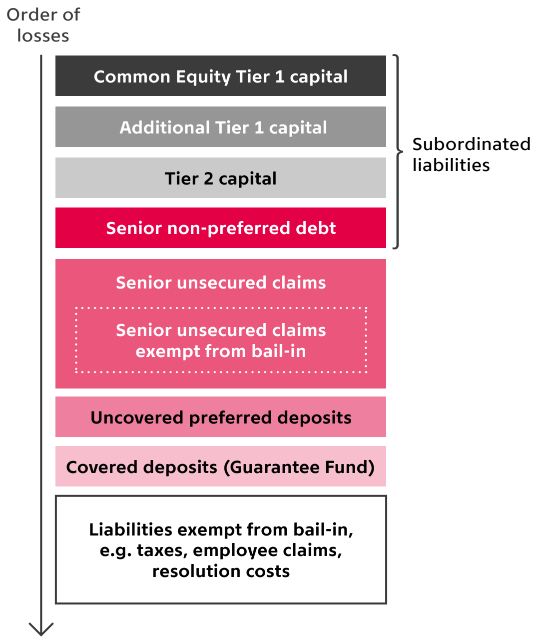
Order of losses in banks

Box 5

When bail-in is performed in a bank, this must be done in accordance with the hierarchy of creditors. This means that the liabilities that rank lowest in the hierarchy of creditors will be bailed in first. All liabilities in a creditor class must have been fully written down or converted (unless they are exempt from bail-in) before the next creditor class is bailed in (waterfall model). If only a partial bail-in is necessary for a creditor class, the losses are distributed equally on a percentage basis among all creditors in the creditor class. The order of losses is illustrated below.

The creditor class of senior unsecured claims comprises many different types of liabilities, including ordinary senior debt, structured notes, derivatives, guarantees, deposits of more than 100,000 euro from large corporations and regular unpaid bills. Senior unsecured claims also include a number of liabilities that are always exempt from bail-in. This includes liabilities to other credit institutions with an initial maturity of less than seven days and liabilities that are critical to day-to-day operations. In a specific crisis situation, Finansiel Stabilitet may also choose to exempt additional liabilities from bail-in if extraordinary circumstances justify this, for example consideration for the stability of the financial system. If, in special cases, Finansiel Stabilitet chooses to exempt certain liabilities from bail-in, it will be possible to replace the exempted liabilities with the Resolution Fund.

When the bail-in tool was introduced in the EU, a number of adjustments were made to the hierarchy of creditors. To protect private individuals and small and medium-sized enterprises, their deposits over 100,000 euro (uncovered preferred deposits) have been given a better position in the hierarchy of creditors than senior unsecured claims, which means that they bear losses after senior unsecured claims. Deposits below 100,000 euro are covered by the Guarantee Fund, and they have been given an even better position in the hierarchy of creditors. No bail-in can be performed on covered deposits. Instead, the Guarantee Fund may contribute an amount equal to the amount by which the covered deposits would have been written down if they had been subject to bail-in. However, the contribution from the Guarantee Fund must not exceed the Guarantee Fund's target level.



many different types of liabilities, including ordinary senior debt, deposits from large corporations over 100,000 euro and derivatives. In the order of losses, senior unsecured claims rank after subordinated liabilities, but before the liabilities that the legislature has decided must have additional protection, for example uncovered deposits from private individuals. Deposits under 100,000 euro are covered by a deposit guarantee scheme (the Guarantee Fund) and are therefore always protected against bail-in.

With BRRD2, a maximum limit has been introduced for the subordination requirement, see Box 6. This means that it is no longer possible for the Danish Financial Supervisory Authority to require full subordination of the MREL requirement for the Danish institutions. In future, part of the MREL requirement can thus be met with liabilities that form part of the creditor class of senior unsecured claims. This means that senior unsecured creditors must now be prepared for the risk of having to make contributions in situations that are regarded as normal loss scenarios from a crisis management perspective. They may either have to contribute by the liabilities that their claims concern being written down or being converted into shares. It is, however, most likely that these liabilities will be converted. Senior unsecured creditors, for example large corporations with deposits over 100,000 euro, should be aware of this risk and take it into account in their risk management.

There is no special safeguard for senior unsecured creditors. It is consequently not a problem that senior unsecured creditors risk having to contribute to the crisis management of a failing credit institution.

Rules on subordination requirement in BRRD2 Box 6

With BRRD2, rules have been introduced to the effect that part of the MREL requirement must be met with liabilities which are subordinated, i.e. liabilities that absorb losses before senior unsecured claims. BRRD2 lays down both a minimum limit and a maximum limit for the subordination requirement.

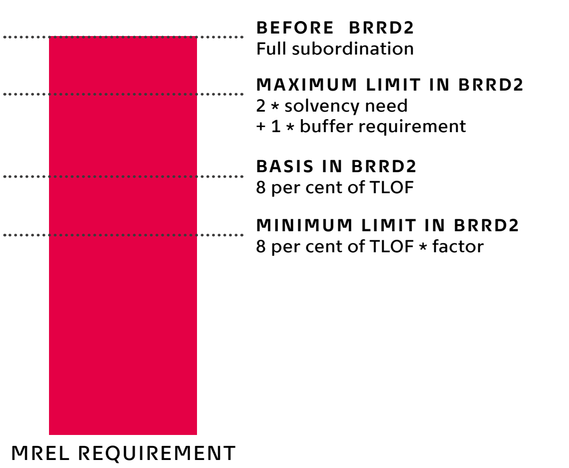
BRRD2 divides the institutions into four size categories, and the subordination requirement depends on the category of the institution. For SIFIs, the subordination requirement must, as a general rule, constitute 8 per cent of total liabilities and own funds (TLOF). The subordination requirement can then be adjusted up to a maximum limit or down to a minimum limit if a number of conditions are met.

The maximum limit is twice the solvency need plus one time the combined buffer requirement (if it is higher than 8 per cent of TLOF). The maximum subordination requirement relates both to compliance with the MREL requirement and to compliance with the combined buffer requirement, which must be met as a separate requirement under BRRD2, see Box 3.

The minimum limit for the subordination requirement is calculated on the basis of a formula in which 8 per cent of TLOF is multiplied by a factor that is less than one.

Under BRRD, there were no rules on subordination of the MREL requirement, and it was consequently up to the resolution authorities in each EU country to decide how stringent a subordination requirement they would lay down. For the Danish institutions, the Danish Financial Supervisory Authority has so far required full subordination of the MREL requirement. This is no longer possible because BRRD2 lays down a maximum limit for the subordination requirement.

The different subordination requirements are illustrated in the chart below.



Subordination of the MREL requirement is an advantage because it helps ensure transparency and a clear legal framework for the institutions' investors and creditors about who will bear losses when. In addition, it makes the crisis management simpler and more flexible if bail-in is used only on subordinated liabilities. For these reasons, it is deemed expedient to lay down as stringent a subordination requirement as possible within the statutory framework.

Regardless of whether or not the liabilities used to meet the MREL requirement are subordinated, they can, however, be used for crisis management of the institution. The maximum subordination requirement thus does not mean that there are less funds available for crisis management of the institution. However, it may mean that the crisis management becomes more complicated.

When the resolution authorities perform a bail-in in a crisis situation, they must write down and convert the liabilities in a creditor class in full before moving on to the next creditor class (waterfall model). If it is only necessary to perform a partial bail-in on the liabilities of a given creditor class, the resolution authorities must distribute the losses proportionately among all creditors in the creditor class. This applies to both the liabilities that are eligible for compliance with the MREL requirement and to the liabilities that are not eligible. This means that, as a general rule, the liabilities for all senior unsecured creditors must be written down or converted by the same proportionate share (stated as a percentage of the liability) – regardless of whether this is, for example, senior debt, deposits from a large corporation of more than 100,000 euro or an ordinary unpaid bill.

However, certain types of liabilities are always exempt from bail-in, see Box 5. In addition, the legislation allows the resolution authorities to choose, in special cases, to exempt certain creditors from bail-in, for example some senior unsecured creditors, and to let the exempted creditors be replaced with the Resolution Fund, see Box 7.

It is important that the resolution authorities use special bail-in exemptions sparingly. It is a cornerstone of the crisis management framework that the institution's investors and creditors must bear the losses. This helps ensure that the institutions are provided with the right risk management incentives. In addition, it has also already been established in the legislation which liabilities are, as a general rule, to be exempt from bail-in. Likewise, it has been established in the legislation which creditors are to be granted special protection – these creditors have been granted a better position in the hierarchy of creditors. A liability should consequently only be exempt from bail-in if there is a very weighty reason for this, for example consideration of financial stability.

Resolution Fund can contribute to crisis management

Box 7

The Resolution Fund is a sector-financed fund which Finansiel Stabilitet can use in certain cases in connection with crisis management of a failing credit institution. The Resolution Fund is financed by annual contributions from the institutions. The target level for the Resolution Fund is 1 per cent of the covered deposits.

The Resolution Fund can be used if this is necessary to ensure effective crisis management. It may, for example, be used to guarantee liabilities, to grant loans to an institution that is subject to crisis management or to acquire assets from the institution. In connection with a bail-in in banks, the Resolution Fund may also contribute to loss absorption or recapitalisation of the bank if it is necessary in special cases to exempt certain creditors from bail-in, for example some of the senior unsecured creditors. However, use of the Resolution Fund in connection with a bail-in requires that minimum 8 per cent of the bank's total liabilities and own funds have already been written down and converted. There is also the limitation that the contribution from the Resolution Fund may correspond to maximum 5 per cent of the bank's total liabilities and own funds.

PUBLICATIONS

NEWS

News offers a quick and accessible insight into an Analysis, an Economic Memo, a Working Paper or a Report from Danmarks Nationalbank. News is published continuously.

ANALYSIS

Analysis from Danmarks Nationalbank focuses on economic and financial matter. Some of the analyses are published with a regular frequency e.g. *Outlook for the Danish economy and Financial stability*. Other analyses are published continuously.

REPORT

Report comprises recurring reports and reviews of the functioning of Danmarks Nationalbank. For instance Report includes the *Annual report* and the annual publication *Danish government borrowing and debt.*

ECONOMIC MEMO

Economic Memo is a cross between Analysis and Working Paper and it often shows the ongoing study of the authors. The publication series is primarily targeted at professionals. Economic Memo is published continuously.

WORKING PAPER

Working Paper presents research projects by economists in Danmarks Nationalbank and their associates. The series is primarily targeted at professionals and people with an interest for academia. Working Paper is published continuously.

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.

DANMARKS NATIONALBANK
LANGELINIE ALLÉ 47
DK-2100 COPENHAGEN Ø
WWW.NATIONALBANKEN.DK

This edition closed for contributions on 3 March 2021

Christine Sif Larsen
Senior Resolution Expert
csla@nationalbanken.dk

Anne Dyrberg Rommer
Head of Resolution Task Force
ady@nationalbanken.dk

FINANCIAL STABILITY

CONTACT

Teis Hald Jensen
Communications and Press Officer

tehj@nationalbanken.dk
+45 3363 6066

SECRETARIAT AND COMMUNICATIONS

DANMARKS NATIONALBANK