

## Discussion paper

Main principles for resolution of small and medium-sized banks and determination of minimum requirements for own funds and eligible liabilities (MREL)

## Introduction

According to the Danish Financial Business Act, the Danish FSA and Finansielt Stabilitet<sup>1</sup> are responsible for preparing resolution plans for banks. These resolution plans should contribute to the best possible resolution of banks to minimise any damage to the economy. In connection with adopting resolution plans, a requirement for own funds and eligible liabilities (MREL) must be determined. The MREL is to be used for loss absorption and recapitalisation if a bank becomes distressed and has to be restructured or resolved. One of the conditions for the resolution plans is that there will be no injection of funds from the state, and thereby from taxpayers.

In the situation where a bank is failing or likely to fail, losses will have to be distributed. Combined with own funds and eligible liabilities, the resolution strategies must contribute to ensuring sufficient loss-absorbing capacity in the bank. The size and composition of the MREL provide the framework for distribution of losses in a resolution.

During the financial crisis, substantial losses were recorded in a number of banks. These losses not only affected shareholders, but also many creditors. Finansielt Stabilitet has calculated that initial dividends regarding simple creditors ranged from 58% to 94% for the eight banks taken over by Finansielt Stabilitet under Bank Package I, including Roskilde Bank, and, so far, dividends have been calculated to range from 80% to 94% for the four banks taken over under Bank Packages III and IV.

Various measures have been implemented to reduce the risk of losses for creditors, including:

- Introduction of requirements for recovery plans
- Introduction of the supervisory diamond
- New and stricter liquidity rules
- Tightening of capital-adequacy rules
- Tightening of the calculation of own funds
- Clarification of impairment regulations.

Due to these measures, banks are now more robust than before. This means that the risk of a bank having losses that exceed its own funds has been reduced. However, it is important to note that the ranking of creditors has also been changed so that, in future, some previously simple claims will be ranked relatively higher than before, and others will be ranked relatively lower, if a situation arises in which losses exceed the bank's own funds and other subordinated claims.

In this discussion paper, the Danish FSA presents its initial considerations on how small and medium-sized banks should be resolved, and how the MREL can be determined.

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<sup>1</sup> Finansielt Stabilitet was established in 2008 with the task inter alia of winding up banks taken over by the government. Together with Finanstilsynet, Finansielt Stabilitet is the Danish resolution authority. According to Danish legislation, Finanstilsynet is responsible for deciding that a bank is failing or likely to fail, and if so Finanstilsynet subsequently transfers control of the bank to Finansielt Stabilitet.

Furthermore, the paper presents a number of considerations regarding the timing for transferring banks to Finansielt Stabilitet<sup>2</sup>. Small and medium-sized banks are generally banks in groups 2, 3 and 4<sup>3</sup>. Finansielt Stabilitet has been consulted, and has contributed to the discussion paper during its preparation.

For the largest banks (SIFIs), in line with the legislation, it has been decided that it should be possible to restructure the banks and send them back to the market with adequate capitalisation to restore market confidence. In accordance with this principle, The MREL is expected to be set at two-times the total capital requirement, including solvency needs and statutory capital buffers.<sup>4</sup>

## **Principles for resolution strategies and MREs**

The Restructuring and Resolution of Certain Financial Undertakings Act allows for controlled resolution of small and medium-sized banks, where viable activities are sold, whereas the remaining activities are temporarily continued and resolved under Finansielt Stabilitet. The MREL for small banks will therefore be lower than for SIFIs, but greater than the MREL that would otherwise apply if a bank were resolved through bankruptcy.

Where banks are resolved through bankruptcy, there will be no need for additional requirements regarding capital or other own funds and eligible liabilities. In this case, simple creditors, including depositors with larger deposits than those covered by the Deposit Guarantee Scheme (DGS), must expect losses as a result of the resolution. Other simple claims, such as bank guarantees provided to customers, claims from suppliers of goods, and claims for damages from customers resulting from poor advice etc., will also be written down. If bankruptcy is the preferred model for resolution of small and medium-sized banks, this is likely to have consequences for the business model of the banks in question. The difference in treatment of simple creditors in relation to SIFIs will strengthen the incentive to focus on SIFIs with respect to provision of bank guarantees and deposits exceeding the DGS.

The authorities and the sector organisations representing the banks share a common understanding that resolution plans should also reduce the risk of losses for simple creditors in the event of a resolution. This objective is not stipulated directly in the legislation, but it is in line with the political agreement on Bank Package IV, and the related agreement with the financial sector, in which it was recognised that the sector and the Danish state were jointly responsible for seeking to avoid unnecessary resolution of banks through Bank Package III, where simple creditors experienced losses. The sector would therefore participate actively in finding solutions by which healthy banks assume the task of wholly or partly taking over activities from banks that get into difficulties.

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<sup>2</sup> In the following, the term 'transfer' refers to situations in which the Danish FSA either withdraws a bank's license, or where the Danish FSA, following consultation with Finansielt Stabilitet, decides that a bank is failing or likely to fail, and that Finansielt Stabilitet can take control of the bank.

<sup>3</sup>The discussion does not include small, specialist banks. The resolution strategy for such banks will be determined following a specific individual assessment. Furthermore, banks in the Faeroe Islands and Greenland are not included, as the new resolution regulations under the BRRD have not yet entered into force in these areas.

<sup>4</sup> This definition of the MREL, which includes statutory capital buffers, is in line with current regulations, and is the definition applied in this discussion paper. With the implementation of BRRD2, the definitions will change, see below.

However, there can be no guarantee that simple creditors will suffer no losses at all. This depends on how large the losses turn out to be for the bank in question. Generally, the higher the amount of own funds and eligible liabilities in the resolution situation, the lower the risk of losses for simple creditors - provided that own funds and eligible liabilities are not simple claims. On the other hand, a lower MREL can more easily be met. The intention of ensuring adequate own funds and eligible liabilities when transferring control to Finansiel Stabilitet may be achieved both by means of an adequate MREL and by quickly introducing resolution measures once the conditions have been met.

As a further objective, the bank's primary functions, such as credit cards and NemKonto accounts, should be available both during and after the resolution of the bank. This is conditional on the bank maintaining its banking license after transferring control to Finansiel Stabilitet.

### **Resolution strategy and valuation**

When the Danish FSA transfers control of a bank to Finansiel Stabilitet, see the principles below, Finansiel Stabilitet will generally perform a so-called 'orderly wind-down'. This means that as many activities as possible are sold, whereas the remaining activities are continued temporarily as an institution owned by Finansiel Stabilitet. The divested activities will be capitalised by the buyer, whereas the remaining activities will be recapitalised by the creditors of the bank, or by the Resolution Fund.

In a resolution, the valuation of assets, performed by an independent valuer in accordance with the Restructuring and Resolution of Certain Financial Undertakings Act, must be fair, realistic and *prudent* ('valuation 2'). As long as the bank is still operating, fair and realistic valuation must be applied ('valuation 1'). The more 'prudent' valuation in a resolution situation will lead to a decline in the value of the bank's assets.

### **Elements of the MREL**

Based on the adopted legislation - the most recent being the Restructuring and Resolution of Certain Financial Undertakings Act of 31 March 2015 - the MREL will comprise the following main elements:

1. The currently applicable solvency need, including
  - a. the minimum requirement of 8% of the total risk exposure amount (pillar 1)
  - b. add-on for risks and conditions that are not fully reflected in the calculation of the total risk exposure amount (pillar 2).
2. MREL additions that will be gradually introduced, and include
  - a. a valuation-2 add-on, generally intended to cover the loss experienced by the bank as a result of the more prudent valuation applied in connection with cessation of normal operations, see above
  - b. a recapitalisation amount, to be used to capitalise those of the bank's activities which, according to the assessment of Finansiel Stabilitet, cannot immediately be sold off in connection with a resolution, and which will therefore have to be operated temporarily by Finansiel Stabilitet.
3. Statutory capital buffers, including a capital conservation buffer of 2.5%, which is gradually being phased in over a four-year transitional period.

Determination of the MREL is subject to uncertainty. The following describes some overall considerations, which are expected to serve as a basis for determining the MREL. These conditions must be further clarified as part of ongoing work. It should be noted that work is currently ongoing at European level to draw up common guidelines, and this work may result in changes that can have implications for Danish implementation.

Furthermore, the European Commission has presented a proposal to revise the regulations regarding crisis management for credit institutions (BRRD2). According to BRRD2, the statutory capital buffers are not included in the MREL. Consequently, the capital used to meet the MREL cannot simultaneously be used to meet the statutory capital buffers.

There will most likely be a need for legislative amendments in connection with implementation of BRRD2. It may also be necessary to clarify the legislation to ensure a higher degree of correspondence with the intentions described in this discussion paper.

### Ranking of losses

In order to protect simple creditors against losses as much as possible, it is necessary that all parts of the MREL carry losses before simple creditors. This is illustrated by the figure below, which shows the bail-in ranking without (on the left) and with (on the right) 'contractual bail-in' requirements (contractual conversion). The same applies for SIFs.

<b>Bail-in ranking without and with contractual conversion</b>		
Own funds	Common Equity Tier 1 capital Hybrid core capital Tier 2 capital	Own funds
Senior debt	Senior unsecured debt	Senior debt with contractual conversion
Other unsecured claims	Eligible deposits from large companies, not covered by the Guarantee Fund Other claims, including legal requirements	Other unsecured claims
Eligible deposits	Eligible deposits from private individuals and small companies, not covered by the Guarantee Fund	Eligible deposits
Covered deposits	Covered deposits – in practice the Guarantee Fund carries the loss	Covered deposits

When there is no conversion requirement, other simple claims (e.g. eligible deposits from large companies not covered by the DGS, guarantees, legal claims, etc.) rank pari passu with senior unsecured debt and before other deposits. When there is a conversion requirement, senior debt will constitute a separate class, and thereby cover losses before simple creditors. Furthermore, senior debt investors will be aware of the risk of conversion and be able to price this risk. A condition for this to work is that the contract stipulates that the liability will be converted once the banking license is withdrawn or control is transferred

to Finansiell Stabilitet. In line with international developments, the MREL must de facto, be subordinated, partly to protect simple creditors, and partly to increase transparency on how losses are borne in connection with a possible resolution of the bank.

It will always be possible to meet the MREL through Common Equity Tier 1 capital or other instruments that may form part of the bank's own funds. Capital instruments being phased out as a result of pre-maturity amortisation or a transitional scheme can be included in full in order to meet the MREL, provided that the remaining term is no less than one year. Such inclusion may be relevant for Tier 2 capital during pre-maturity amortisation and state hybrid core capital held at the bank after 1 January 2018. When the remaining term of this capital is less than one year, it can no longer be included.

## **The size of the MREL**

The valuation-2 and recapitalisation add-on in the MREL cannot be determined on the basis of one set of factors for all banks, but they have to be determined individually for each bank. This section describes the overall considerations and preliminary estimates regarding the size of the add-ons.

The exact figures for each individual bank depend on a number of factors, including the composition of the balance sheet, impairments, solvency needs and lending quality. There is no immediate connection between the calculation of the two additions, and, on the existing basis, it is not possible to accurately calculate the individual MREs. The figures below should therefore be considered as preliminary.

### **Valuation-2 addition**

The valuation-2 addition should cover the part of the expected additional impairments in a resolution that cannot be included in the solvency need. In the long term, the additional impairments should be based on the European Commission's valuation regulations, but since these regulations have not yet been issued, the estimates below are based on the valuation principles currently likely to be applied by the independent valuer(s) appointed by Finansiell Stabilitet.

Generally, the additional impairments will be calculated on the basis of a more prudent assessment of the need for impairments for individual exposures, less the value of the collateral provided (net exposure), based on a prudent assessment.

According to preliminary assessments, the valuation-2 addition is generally estimated to be between 2% and 5% of the risk exposure amounts.

The exact figures depend on the composition of the balance sheet and the lending quality as well as impairments and solvency reserves already made by the bank.

### **Recapitalisation amount**

The size of the recapitalisation amount is determined on the basis of what Finansiell Stabilitet expects can be sold in the resolution. The point of departure is that all loans to private and corporate customers below a certain threshold, as well as bonds portfolios etc., can be sold quickly. Furthermore, it is assumed that larger corporate loans cannot be disposed of, but will be part of the activities that are gradually discontinued. The recapitalisation amount must adequately capitalise the remaining portfolio, which cannot be divested.

Capital adequacy for the remaining part can be calculated according to existing solvency regulations, though without a pillar-2 addition and without a capital buffer.

Based on reported figures, the expected divestment can be estimated to reduce risk-weighted exposures by 60-80% for a typical bank. Consequently, the recapitalisation amount is the remaining 20-40%, multiplied by the pillar-1 requirement of 8% of risk-weighted assets, i.e. between 1.6% and 3.2% of risk-weighted assets. As mentioned previously, the exact figures will depend on the balance sheet composition of each individual bank. The capital requirement is only the pillar-1 requirement, and consequently includes neither the pillar-2 requirement, nor the recapitalisation buffer, since the objective is a wind-down.

During the actual resolution situation, it may turn out that it is possible to sell more or fewer assets than initially assumed in the resolution strategy. As long as there are positive net assets, Finansiell Stabilitet has certain opportunities for contributing to the recapitalisation through the Resolution Fund. In practice, the recapitalisation amount can therefore also serve as the buffer which, from experience, is often required.

### **Capital buffers**

Once the capital conservation buffer has been fully phased in, it will amount to 2.5% of risk-weighted exposures. In addition to this, banks will have to hold a countercyclical capital buffer, which is currently set at zero. Usually, a bank is most likely to become distressed during economic recession when the countercyclical buffer is zero.

The purpose of the capital buffers is to enable the banks to react before they are faced with more binding requirements.

### **Total capital need**

The total solvency need of banks currently amounts to an average of approx. 11.2% of the risk-weighted exposures. To this should be added the capital buffers and the two MREL additions.

Estimates of the two MREL additions can be adjusted under certain conditions. The preliminary estimates do not take into account that, in a resolution situation, Finansiell Stabilitet can dispose of any shareholdings the bank may have in other financial undertakings<sup>5</sup>. The proceeds of any such disposal may contribute to reducing the losses

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<sup>5</sup> For many banks, holdings of shares must be deducted in the solvency statement, and therefore they constitute a potential reserve.

arising from the resolution, and thereby the MREL. However, the size of these proceeds is uncertain.

Furthermore, it has not been taken into account that a compensation for termination of contract may be due to the bank's data centre, and other costs may be payable as a result of the resolution. These costs can potentially increase the losses relating to the resolution, and thereby the MREL. It is expected that the sector will reduce the costs of terminating contracts.

Finally, work is ongoing in relation to implementation of new accounting regulations (IFRS9), and the upcoming European valuation standard. Depending on the design of these, it may be necessary to adjust the MREL.

## **Phase-in**

The Danish FSA estimates that almost half of the small and medium-sized banks are already able to comply with the MREL today. Furthermore, the Restructuring and Resolution of Certain Financial Undertakings Act allows for gradual phasing-in of the MREL. If the MREL is phased in over five years, for instance, by far the majority of banks will be able to meet the requirement through retained earnings. It will also be possible to raise the required capital on the capital markets, or to reduce the balance sheet and thereby lower the capital need.

When determining the phase-in period, banks' possibility to meet the MREL by retaining earnings, the phase-in period in neighbouring countries and developments in financial and economic conditions should be taken into account. The phase-in profile may also allow for the phasing-in of the capital conservation buffer up to 2019. The longer the phase-in period, the greater the opportunities for meeting requirements by retaining earnings. However, a longer phase-in period will also make simple creditors more vulnerable, because they will not enjoy the full level of protection from MREL in a resolution situation until the MREL has been fully phased in.

## **Withdrawal of license and transfer to Finansiell Stabilitet**

The current regulations on actions regarding non-compliance with solvency needs and MREs give Finansiell Stabilitet considerable discretion with respect to the timing of transferring control of the bank to Finansiell Stabilitet. According to existing regulations, a bank's license can potentially be withdrawn depending on the specific circumstances, if the solvency ratio is anywhere between the strict pillar-1 requirement of 8% of risk-weighted exposures and the total MREL.

In the event of non-compliance with the MREL, including the statutory capital buffers, the Danish FSA must make a specific assessment of the consequences that the non-compliance is to have.

It follows from the explanatory notes to the regulations regarding the MREL that, as a general rule, any non-compliance with the MREL is considered a gross violation of the regulations. The ultimate sanction on gross violation and repeated cases of non-compliance is that



license will be withdrawn. In practice, this means that control is transferred to Finansiell Stabilitet.

Control is transferred to Finansiell Stabilitet when the Danish FSA assesses that the bank is failing or likely to fail, and the Danish FSA assesses that it cannot be expected that other measures, including measures taken by the private sector or the Danish FSA, can prevent resolution of the bank within a reasonable time limit.

When assessing the consequences of non-compliance with the MREL, the Danish FSA will therefore have to set a shorter or longer time limit for compliance with the requirement. The extent and development of non-compliance with the MREL will be a central element in the Danish FSA's determination of the time limit.

In principle, a bank can be non-compliant with MREL of an amount less than the capital buffers without transferring the control of the bank to Finansiell Stabilitet. In this situation, the Danish FSA has several reaction options. For example, as a first action, the Danish FSA is likely to order that the institution restores its capital.

Once the capital buffers are deemed to have been exhausted, the situation will be different. The scope of action for the Danish FSA is severely limited when the objective is to reduce the risk of losses for simple creditors.

In order to achieve the resolution strategy's goal to reduce the risk of losses for simple creditors, the Danish FSA should generally transfer control to Finansiell Stabilitet when the MREL falls below the solvency need plus the valuation-2 addition and the recapitalisation amount. As mentioned above, in its assessment of whether to transfer control of the bank to Finansiell Stabilitet, the Danish FSA will consider whether the bank can resolve the issues and meet the MRELS within a reasonable time limit. Since neither the bank, nor the Danish FSA is able in practice to monitor continuously compliance with the MREL, the degree of non-compliance with the MREL can vary.

If non-compliance with the MREL is not caused by losses in the bank, but rather by the bank being unable to refinance issues of MREL instruments, when the remaining term falls below one year, other reactions are possible. A remaining term of no less than one year is a formal requirement for the issues to be included in the MREL compliance calculation. These amounts will be available for loss absorption in a resolution for up to a year, even though the amount cannot formally be included in the MREL compliance calculation. In this case, the bank will usually be granted up to one year's respite before transferring control. If the bank is granted more time, debt subordinated to simple creditors may possibly be repaid, meaning that the risk of losses for simple creditors increases.

The ideal scenario would be to find a market-based solution before transferring control. This approach is also in line with the political agreement on Bank Package IV, and the related agreement with the financial sector. According to this agreement, the Danish FSA will organise its workflows and procedures to ensure that measures to prepare for taking over a failing bank are launched as early as possible, and, if possible, well before setting a deadline for restoring the capital.

## Questions

The Danish FSA wants to consult stakeholders about the considerations outlined above. In particular, the Danish FSA would like stakeholders to express their views on the following questions:

1. Should it also be an essential objective of resolution strategies and MREs that the risk of losses for simple creditors is reduced? If yes, should the objective be a very low probability of losses in both SIFs and non-SIFs?
2. Does the method for determining the MREL addition as the sum of the valuation-2 addition and the recapitalisation addition reflect the capital needed in a resolution?
3. Is it reasonable to base the determination of the valuation-2 addition and the recapitalisation amount on the principles described? What are the possibilities for reducing the contract-termination compensation payments to the banks' data providers? How is the valuation of any shareholdings in other financial undertakings calculated? What other factors should be taken into account?
4. How can it be ensured that the sector participates actively and timely in finding solutions where healthy banks wholly or partly take over activities from banks that get into difficulties?
5. Should banks be granted a maximum of one year to refinance MREL instruments in the event of non-compliance with the MREL because refinancing is not possible?
6. Is it a condition for implementation of the outlined resolution strategy - and thereby the objective of reducing the risk of losses for simple creditors - that, following a specific assessment, control be transferred to Finansielt Stabilitet when it is ascertained that, within an appropriate time limit, the bank has not rectified the situation that MREL has fallen below the solvency need plus the valuation-2 addition and the recapitalisation amount? What will be a reasonable level of risk in relation to that valuations by Finansielt Stabilitet may reveal negative net assets?
7. Does a five-year phase-in period take into account, on the one hand, that banks need time to meet the MREL, and, on the other hand, that action should be taken quickly to increase the protection of simple creditors against losses?

The Danish FSA requests that any responses to these questions be received by the Danish FSA by no later than 28 February 2017. Please send responses to [resolution@ftnet.dk](mailto:resolution@ftnet.dk).