DANMARKS
NATIONALBANK

Secretariat to the Financial Stability Board
Bank of International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

fsb@bis.org

Chairman of the Board of Governors
Havnegade 5
DK-1093 Copenhagen K
Phone: +45 33 63 63 63
Fax: +45 33 63 71 01
nationalbanken@nationalbanken.dk
www.nationalbanken.dk

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**Response by Danmarks Nationalbank to the Financial Stability Board's consultation on effective resolution of systemically important financial institutions**

Danmarks Nationalbank strongly supports the commitment of the Financial Stability Board to seek ways to effectively resolve systemically important financial institutions (SIFI's). Creating a well-defined framework of powers and tools is essential for dealing with failing SIFI's in a way that minimises the potential impact on financial stability. Danmarks Nationalbank supports the objectives and the direction presented in the FSB consultation and finds it important that further progress is made to ensure level playing field across countries as well as for SIFI's and non-SIFI's.

SIFI's are central to the economy and the financial system. The consequences if a SIFI were to fail would be so far-reaching that the requirements for such institutions, both in terms of regulation and supervision, should be so strict that the risk of failure is eliminated to the greatest extent possible. It is of crucial importance that the focus on prevention and preparation is maintained. This will enhance authorities' ability to deal with potential and emerging problems in SIFI's and minimise the risk of failure.

Danmarks Nationalbank has touched upon several of the issues raised by the Financial Stability Board in its response to the European Commission's consultation on the technical details of a possible EU framework for bank recovery and resolution. Please find the response attached.

Yours sincerely,

Nils Bernstein

DANMARKS
NATIONALBANK

Board of Governors
Havnegade 5
DK-1093 Copenhagen K
Tlf.: +45 33 63 63 63
Fax: +45 33 63 71 03
nationalbanken@nationalbanken.dk
www.nationalbanken.dk

European Commission
DG Internal Market and Services
Rue de Spa 2
B-1049 Brussels
Belgium

markt-crisis-management@ec.europa.eu

**Response by Danmarks Nationalbank to the European Commission's public consultation on the technical details of a possible EU framework for bank recovery and resolution**

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Danmarks Nationalbank welcomes the opportunity to comment on the European Commission's public consultation on the technical details of a possible EU framework for bank recovery and resolution.

## 1. General observations

The financial crisis has evolved differently in Member States resulting in various bank recovery packages and resolution schemes. These fragmented approaches illustrate the shortcomings of the current crisis management framework in the EU and call for a more consistent way in addressing a financial crisis.

In view of the increasing inter-dependencies between financial systems and the need to address the possible systemic impact of the failure of cross-border banking groups, domestic crisis management frameworks need to be further aligned. Danmarks Nationalbank therefore welcomes the initiative taken by the European Commission to create a European framework for crisis prevention, management and resolution.

Danmarks Nationalbank shares the view of the European Commission that the overriding objective of the new European framework should be that all banks can be allowed to fail in a way that safeguards the stability of the financial system and minimises public costs and economic disruption.

On these grounds it is Danmarks Nationalbank's opinion that the European Commission should pursue the notion that all banks should be subject to a mandatory resolution regime. A mandatory resolution regime will provide the authorities with effective tools to deal with banks that get into financial difficulty in a manner that supports the public interest in financial stability and continuity of banking services. Furthermore, it will foster transparency,

restore a healthy banking sector and contribute to an effective single market in banking.

To be credible, the special resolution regime should be accompanied by measures reducing moral hazard. The regime should clearly reflect the authorities' firm intention to let shareholders and unsecured creditors bear losses to avoid regulatory forbearance and bail-outs. In our view this is also in line with the European Commission's principle and objective to reduce moral hazard through appropriate allocation of losses to shareholders and creditors and thereby protecting public funds.

As a final introductory remark Danmarks Nationalbank finds it important to stress that central banks are an important factor in crisis management and resolution. This must be kept in mind, when further developing and drafting the framework. Proper involvement of central banks is crucial to successfully mitigate systemic disruptions in a recovery and resolution process.

## 2. Specific comments

**Supervision, preparation and prevention**

Danmarks Nationalbank agrees with the European Commission's approach to put emphasis on prevention and preparation. This will enhance preparedness of authorities to deal with potential and emerging problems in banks and minimise the risk of having to resort to ad hoc based solutions involving public funds.

***Recovery and resolution plans***

The European Commission proposes that recovery and resolution plans should be drawn up to enable early action in the event of a material deterioration of a bank's financial situation with the aim to restore the viability of the bank or prepare for an orderly winding-up.

The successful management and resolution of a crisis requires careful ex ante preparation to establish optimal processes and steps to ensure effective coordination and implementation of necessary arrangements.

Danmarks Nationalbank considers contingency plans to be a vital tool to facilitate recovery and resolution of ailing banks and fully supports the European Commission's proposal to develop this necessary preparatory tool. We believe that recovery and resolutions plans must be discussed proactively between the relevant supervisors, resolution authorities and central banks and that the microprudential viewpoint of the individual plans should be complemented by a macroprudential perspective entailing a holistic analysis of the potential aggregate impacts on the financial system. Furthermore, central banks should be involved in assessing the potential action of the resolution authority given that one of the main objectives of a resolution process is to avoid systemic disruptions. Finally, we find that sufficient

involvement of the banks concerned should be ensured, as they are able to contribute with important information that has to be addressed and taken into consideration when assessing the recovery and resolution plans. This will also help reduce moral hazard. The management should not be released from its responsibility to ensure the functioning of the bank, including having effective plans to deal with sudden stress.

***Intra-group financial support***

The European Commission suggests that intra-group financial support could be acceptable prior to insolvency and outside of resolution under certain circumstances. To facilitate the execution of a financial support agreement in the event of sudden distress in a group entity a preliminary agreement setting out the conditions for asset transferability could be signed.

Asset transfers on commercial terms take place within most banking groups as part of their regular liquidity management. When a crisis emerges in one or more group entities intra-group financial support may be a sound and responsible solution and in the best interest of the banking group as a whole. However, we must bear in mind that intra-group financial support arrangements contain an inherent risk of contagion. This risk must be minimised to the greatest extent possible by defining the respective legal obligations, including the trigger conditions. No transfer should be allowed, if this means that another group entity potentially becomes at risk not to fulfil the capital requirements. It is imperative that the framework ensures adequate flexibility to contain risks associated with the transfers. The potential role of guarantees as a tool to mitigate risks associated with asset transfers should be a point for further study by the European Commission.

Danmarks Nationalbank supports further work in the field of developing a framework to facilitate intra-group financial support. We view, however, the design of an intra-group financial support arrangement to be legally challenging. Basing the intra-group financial support arrangement on the economic interests of the banking group would risk blurring the fundamental concept of separate corporate legal personality, which is the basis on which the expectations of financial market participants are formed. The concept must be ensured to avoid uncertainty in the allocation of risk and responsibility. Any uncertainty on this point can have a negative impact on the banks funding possibilities and thus undermine financial stability.

**Early intervention**

A common set of intervention tools should be available to all supervisors at certain predefined stages of early stress. Arrangements and tools for crisis management should be flexible and designed to allow for adaptation to the specific features of a crisis and the individual bank involved.

The early intervention tools suggested by the European Commission seem to be sufficiently comprehensive and are broadly viewed to strike a fair balance between the need for authorities to be able to intervene at an early stage and at the same time limiting inference with third party rights. At the early intervention stage interference with third party rights should be as limited as possible. Therefore, if powers such as appointing a special manager are used, legal certainty must be ensured by precisely defining the limits to the exercise of the power. That said Danmarks Nationalbank does not at this stage see the need for a tool allowing authorities to take over the management of a bank. Less intrusive measures such as removing one or more members of the management are available for authorities today and are viewed to be more appropriate at the early intervention stage. The management should remain responsible for the banking operations with the accompanying potential liabilities for damages.

**Bail-in instruments**

It is crucial that we create a robust system that can survive without government interference and assistance next time a crisis occurs. A debt write down and conversion mechanism (bail-in) seems to be an efficient tool within the context of bank recovery and could contribute to the safeguard of financial stability. The practical outcome of the bail-in approach would be restoring the going concern, when other resolution tools are judged not feasible, due to the overarching need to protect the financial system and safeguard financial stability.

Danmarks Nationalbank supports further work in developing an efficient bail-in mechanism. Before introducing such a mechanism there is, however, a need for further in depth analyses to clarify the practical implications of bail-in instruments, not least the legal specification of triggers, how to cope with data-uncertainty and the potential behaviour of investors when an institution approaches a trigger. There is among other things a need for accurate and detailed case-studies on, how market reaction would be to a debt write down tool and a debt conversion tool, respectively, including an assessment as to which tool would have less negative impact on market behaviour, fire sales by debt-holders and arbitrage opportunities.

In order to reduce the uncertainty surrounding bail-in instruments, transparency is a necessity. To this end, the bail-in design should contain clearly defined trigger conditions. Moreover, the bail-in design should not allow for discrimination among equally ranked creditors, as this would conflict with the general principle of equal treatment. The regime should seek to maintain the priority ranking and equitable treatment of classes of creditors.

**Resolution**

A renewed framework for crisis management and resolution should make it possible for authorities to quickly resolve failing banks while preserving continuity of vital banking services. Ordinary bankruptcy proceedings are focused on achieving the best outcome for creditors generally and will not necessarily provide for sufficient means to address financial stability concerns. Furthermore, application of ordinary insolvency law might lead to withdrawal of essential banking businesses, which are in the public best interest to maintain. A mandatory resolution regime would eliminate this likelihood. Danmarks Nationalbank encourages the European Commission to establish a mandatory resolution regime for failing banks that enables the authorities to use the necessary resolution tools to safeguard the functioning of the financial system.

Danmarks Nationalbank agrees with the European Commission's proposals for resolution tools and finds these sufficiently comprehensive to allow resolution authorities to effectively deal with failing banks. It is significant that sufficient discretion would be retained to allow the selection of the most appropriate resolution tools. However, due regard to stakeholders rights must be paid. The action taken in any individual case must be proportionate to the aims pursued.

Danmarks Nationalbank recognises the need for the regime to operate within the requirements of European Community law obligations, including those relating to state aid. It is therefore important that the regime enforces burden sharing within the financial sector and avoids public support. Proper burden sharing will increase the incentive within the financial sector to strive for private solutions rather than letting a failing bank be resolved by the authorities, as they will ultimately bear the costs, but without any influence as to how the bank is wound up.

**Group resolution**

Danmarks Nationalbank recognises the importance of close and effective communication concerning cross-border banking groups. Clarifying the responsibilities for cross-border banking groups is key to further progress on cross-border crisis resolution in the EU. We believe that cross-border crisis resolution could be facilitated through already existing and new Cross-Border Stability Groups as defined in the 2008 Memorandum of Understanding on cooperation between the financial supervisory authorities, central banks and finance ministries of the European Union on cross-border financial stability. These groups could serve as a useful and effective forum to facilitate group wide solutions in case of cross-border crises.

**Financing arrangements**

Danmarks Nationalbank supports the European Commission's proposal on setting up resolution funds at national level and shares the view that these funds can be incorporated to a certain extent in the existing structure of the deposit guarantee schemes to exploit synergies. Financial resources available for deposit pay-out should, however, be ring-fenced within the balance of the deposit guarantee schemes and should not be merged with the funds of the resolution fund.

When specifying the contributions for the resolution funds authorities should be able to pay proper consideration to the diversities of credit institutions, including risk exposure and the extent to which they already are included in comparable structures with committed fees. Calculations solely on the basis of total liabilities are not sufficiently flexible.

Yours sincerely,

Per Callesen