



# DENMARK

## FINANCIAL SECTOR ASSESSMENT PROGRAM

December 2014

### CRISIS MANAGEMENT, BANK RESOLUTION, AND FINANCIAL SECTOR SAFETY NETS—TECHNICAL NOTE

This Technical Note on Crisis Management, Bank Resolution, and Financial Sector Safety Nets on Denmark was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in December 2014.

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## CRISIS MANAGEMENT, BANK RESOLUTION, AND FINANCIAL SECTOR SAFETY NETS

Prepared By  
**Monetary and Capital Markets  
Department, and Legal  
Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program Update in Denmark. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at:

<http://www.imf.org/external/np/fsap/fssa.aspx>.

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## Glossary

BRRD	Bank Recovery and Resolution Directive
CMG	Crisis Management Group
COAG	Cross-border Cooperation Agreements
CRD	Capital Requirements Directive
DCG	Danish Coordination Group
DFSA	Danish Financial Supervisory Authority ( <i>Finanstilsynet</i> )
DGS	Deposit Guarantee Scheme
D-SIB	Domestic Systemically Important Bank
DN	Danmarks Nationalbank
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
EU	European Union
FSC	Financial Stability Company ( <i>Finansiel Stabilitet</i> )
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
GF	Guarantee Fund for Depositors and Investors ( <i>Garantifonden for Indskydere og Investorer</i> )
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
IADI	International Association of Deposit Insurers
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions
MCI	Mortgage Credit Institution
MoBG	Ministry of Business and Growth
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MPE	Multiple Point of Entry
RRP	Recovery and Resolution Plan
RWA	Risk Weighted Assets
SIB	Systemically Important Bank
SIFI	Systemically Important Financial Institution
SPE	Single Point of Entry

## EXECUTIVE SUMMARY

**This note<sup>1</sup> elaborates on the findings and recommendations made in the Financial Sector Assessment Program (FSAP) Update for Denmark in the areas of crisis management, bank resolution, and financial sector safety nets.** The findings are based on a desk review of relevant legal and policy documents, as well as extensive discussions with the Danish authorities and private sector representatives during the mission (June 17–July 2, 2014), taking into account emerging international good practices (notably the Key Attributes of Effective Resolution Regimes for Financial Institutions and Core Principles for Effective Deposit Insurance Systems).

**The authorities' response to the crisis was prompt and decisive.** The Danish financial sector experienced significant stress during the global crisis, prompting substantial public support. Banks' access to funding was ensured through large-scale government guarantees, while recapitalization instruments were made available to buttress banks' regulatory capital positions. The financial sector has paid for the support measures, resulting in a windfall for the Danish government. In anticipation of the expiration of the government guarantees, the authorities introduced a resolution scheme with bail-in features in October 2010.

**The Danish resolution scheme has allowed the authorities to deal with mounting distress while minimizing costs for taxpayers.** The scheme has enabled the orderly winding-up of the affected banks by providing for a transfer of all assets, and part of the liabilities, to the Financial Stability Company (FSC) or third-party acquirers. As part of this scheme, losses have been allocated to the private sector through the write-down of claims from shareholders as well as uninsured and unsecured creditors, including holders of senior debt and large depositors.

**Going forward, the authorities are encouraged to further strengthen the resolution framework in line with the Bank Recovery and Resolution Directive (BRRD) and emerging international good practices.** In particular, an administrative resolution authority should be established and provided with a sufficiently broad mandate, operational independence, a robust governance structure, adequate resources, and legal protection. Moreover, the resolution framework should be enhanced to make feasible the resolution of all banks without systemic disruption and without exposing taxpayers to loss, *inter alia* via (i) the introduction of additional powers to affect and support resolution actions; (ii) further qualitative and quantitative triggers for early entry into resolution; (iii) the preparation of resolution plans and resolvability assessments, at least for systemically important firms; and (iv) a limitation of legal remedies to monetary compensation. The legislative work to implement the relevant EU legislation is already in process. Against a backdrop of potential spillovers to and from the Nordic-Baltic banking system, the authorities are encouraged to pursue continued harmonization of national resolution regimes, including regarding the application of bail-in requirements, and closely coordinate

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<sup>1</sup> This note was prepared by Constant Verkoren (Monetary and Capital Market Department) and Carine Chartouni (Legal Department.)

resolution strategies at a regional level for those institutions whose failure may generate cross-border spillovers.

**Other components of the safety net are broadly adequate, but there is scope for further improvement.** In particular, targeted enhancements of the Deposit Guarantee Scheme (DGS) should be considered, including enhanced governance arrangements, fortified funding mechanisms (including the introduction of a robust public-backstop), and the removal of mandatory offsetting. In addition, the creditor hierarchy should be amended to provide (insured) depositors with preferential claims on the assets of a failed bank, in line with BRRD requirements. Furthermore, Denmark's Nationalbank (DN) should be provided explicit power to grant emergency liquidity assistance (ELA) and prepare internal policy guidelines.

**This note is structured as follows.** Following a brief overview of the Danish financial system and the implications of the financial crisis for Denmark, Chapter II summarizes the existing institutional framework and coordination arrangements for crisis management—domestically and on a cross-border basis. Chapter III discusses aspects related to crisis preparedness, whereas Chapter IV covers early intervention as the “first line of defense” against emerging crises. The Danish toolkit for crisis management—comprising crisis containment measures, emergency liquidity assistance (ELA), the resolution regime, and arrangements for bank liquidation—is discussed in Chapter V. Chapter VI comments on the Danish Deposit Guarantee Scheme. Finally, observations on the legal protection can be found in Chapter VII.

**Table 1. Recommendations on Crisis Management, Bank Resolution and Safety Nets**

Recommendations	Priority 1/	Institution
<b>Institutional framework</b>		
- Designate an administrative resolution authority.	Short term	MoBG
- Clarify the role of each agency involved in the resolution process and formalize its interaction with other authorities.	Short term	All
<b>Cross-border coordination</b>		
- Establish crisis management groups and formalize firm-specific cooperation in matters pertaining to resolution.	Short term	FSC, DFSA
- Continue to pursue regional harmonization of national resolution regimes (e.g., the application of bail-in requirements) and introduce mechanisms to give effect to foreign resolution actions.	Medium term	MoBG, FSC
<b>Crisis preparedness</b>		
- Prepare, at least for domestic SIFIs, resolution plans and resolvability assessments and provide further guidance on recovery plans.	Short term	FSC, DFSA
- Conduct recurrent crisis management simulations (also at a regional level).	Medium term	All
<b>Financial support</b>		
- Amend framework to provide for the Denmark's Nationalbank's (DN) explicit power to grant ELA and prepare (internal) policy guidelines.	Medium term	DN
- Strengthen funding arrangements for resolution purposes.	Short term	MoBG
<b>Resolution framework</b>		
- Expand resolution toolkit, inter alia, by introducing early resolution triggers and additional resolution powers.	Short term	MoBG, FSC, DFSA

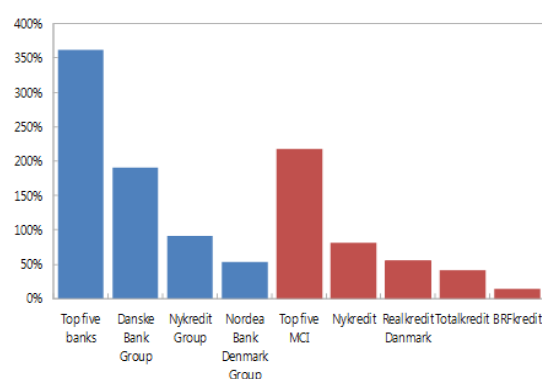
Recommendations	Priority 1/	Institution
- Explicitly limit judicial review to monetary compensation.	Short term	MoBG
<b>Bank liquidation</b> - Introduce depositor preference.	Short term	MoBG
<b>Deposit guarantee scheme</b> - Enhance the DGS, inter alia by strengthening governance arrangements, shortening maximum payout periods, fortifying funding (including back-stop arrangements), and removing mandatory offsetting.	Medium term	MoBG
1/ Short-term indicates within 18 months; medium-term indicates within 18 months to three years.		

## THE FINANCIAL CRISIS IN DENMARK

**1. Denmark's financial system is large and interconnected at a regional level** (Figure 1 and 2). The banking sector, which is composed of banks and mortgage credit institutions (MCI) accounts for two-thirds of the financial sector assets and is over four times the domestic GDP. Danske Bank Group (with total group assets at end-2013 exceeding 180 percent of GDP) dominates the banking system and has large cross-border operations in the Nordic and Baltic countries. From a home-country perspective, Danske Bank has lending and deposits market shares ranging from 5–10 percent in the Nordic countries, while about 30 percent of the group's credit exposures are related to Nordic clients. The Swedish-headquartered Nordea, the second-largest bank in Denmark, accounts for a deposit market share for both households and corporates of about 25 percent and lending market shares around the 20 percent mark.

**Figure 1. Asset Size Banks and Mortgage-Credit Institutions**

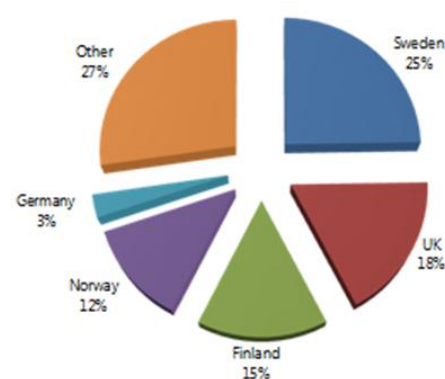
(percentage of GDP, end-2013)



Sources: Danmarks Nationalbank; staff calculations

**Figure 2. Danish Banking System's Foreign Exposures**

(share of total foreign claims, 2013 Q4)



**2. The Danish financial sector experienced significant stress during the global crisis.** Real GDP fell by nearly 6 percent in 2009, reflecting in part the housing bust. Banks experienced a severe liquidity squeeze and registered substantial losses from impairments and write-downs (of about 8½ percent of GDP). The problems became apparent with the failure of Roskilde Bank



in the summer of 2008 (Box 1). In the initial phase of the crisis, substantial public intervention in the form of funding guarantees and capital injections was necessary to maintain financial stability. However, starting in 2010, a new resolution regime was introduced, allowing the authorities to resolve distressed banks in a way that minimized public sector support by imposing losses on private creditors.

### Box 1. The Failure of Roskilde Bank<sup>1/</sup>

In July 2008, Roskilde Bank—Denmark’s eighth largest bank with a balance sheet of just under DKK 43 billion (€5.75 billion at the exchange rate prevailing at the time) and about 105,000 customers—encountered severe financial distress, inter alia, resulting from financial market turbulence and a sharp rise of loan impairments.

At the bank’s request, the DN granted the latter an unlimited liquidity facility that was partly guaranteed by the Danish banking sector—via a newly created special purpose vehicle (DPB) and the Danish state. The facility was authorized by the European Commission as rescue aid on July 31, 2008, with the Danish authorities committing to submit, within six months, a restructuring or liquidation plan for the bank.

In August 2008, it became apparent that the rescue package was insufficient to address the bank’s persistent weaknesses. In the absence of private solutions, DN and DPB acquired Roskilde’s assets and liabilities (with the exception of hybrid capital instruments and subordinated debt) via a newly created entity (‘Roskilde New’).

The purchase price for the transferred assets was set at DKK 37.3 5 billion (around €5 billion), on top of which a capital contribution of DKK 4.5 billion (around €603 million) was provided to restore Roskilde New’s capital position. The aforementioned liquidity facility was prolonged and it was decided that the transferred liabilities would be redeemed in full, with any upside resulting from the orderly wind-down of Roskilde New allotted to the original bank’s equity holders, hybrid capital investors, and subordinated creditors following the satisfaction of all of its liabilities.

In September 2008, agreements were reached with three different Danish banks on the sale of various branches of Roskilde New. Combined, the buyers agreed to acquire about DKK 10 billion (around €1.3 billion) of loans and deposits of DKK 5 billion (€670 million), with the difference to be paid in cash, including DKK 550 billion in goodwill. The remainder of Roskilde is being gradually wound down, following a transfer to FSC in August 2009.

An independent review by *Rigsrevisionen*, the Danish State Auditor, concluded that the DFSA was aware of the emerging problems in Roskilde, having supervised the entity in accordance with its guidelines, but it failed to conduct a sufficiently systematic follow-up. The review prompted a number of enhancements of the Danish prudential supervisory framework, inter alia, resulting in greater transparency of firms’ compliance with Pillar II solvency requirements.

<sup>1/</sup> Based on press release from the DN (August 24, 2008) and European Commission (July 31 and November 5, 2008), and the report from *Rigsrevisionen* (<http://uk.rigsrevisionen.dk/media/1887532/14-2008.pdf>).

**3. Amidst international turbulence, the impact of the financial crisis was magnified by structural weaknesses ingrained in the banking system prior to the crisis.** As highlighted by the committee tasked to investigate the financial crisis in Denmark,<sup>2</sup> the collapse of wholesale funding markets in the wake of the bankruptcy of Lehman Brothers had a significant impact on Danish banks that had become reliant on interbank lending to finance their rapidly expanding balance sheets. The leveraging-up of banks' balance sheets, in turn, reflected a collective underestimation of risks in the pre-crisis period, notably vis-à-vis real estate markets that had seen significant price increases. Moreover, gaps in financial regulation provided banks with greater opportunity to pursue riskier business models and increase leverage, while weaknesses in institutions' governance eroded lending standards. Although the increased risk taking was, to a certain extent, flagged by the DN and DFSA, corrective action remained limited amidst (i) inadequate tools to address rapid lending growth; (ii) a compliance-based (rather than risk-based) supervisory approach; and (iii) an insufficient legal basis for proactive interventions in banks' business models.

**4. The repair of the Danish financial sector remains in train.** Reliance on wholesale short-term funding by commercial banks has decreased and liquidity has improved. All the large commercial banks returned to profitability in 2012, but earnings remain under pressure from declining lending volumes and compressed margins, reflecting the decline of interest rates and increased competition. A number of nonsystemic banks continue to make losses and to have high levels of impairments. The total capital adequacy ratio for the Danish banking system has increased from 12 percent in 2007 to 18 percent in June 2014, while low average risk weights seem to reflect the high share of mortgage lending as well as low loss-given-default rates.

**5. At the time of the mission, efforts to strengthen the bank resolution framework were ongoing.** A credible resolution regime for systemically important banks (SIBs) remains important to help reduce the implicit "too-big-to-fail" subsidy that—following a sharp decline after the allocation of losses to senior unsecured creditors as part of the resolution of Amagerbanken and Fjordbank Mors in 2011—flared up again in 2012, amidst market turmoil in the euro area.<sup>3</sup> The authorities are in the process of transposing the BRRD, which seeks to harmonize and upgrade the tools for dealing with bank crises across the European Union. Furthermore, a possible voluntary entry into the euro area banking union would make the Danish banking system subject to the Single Resolution Mechanism that was adopted by both the European Parliament and the Council in July 2014.<sup>4</sup>

<sup>2</sup> In January 2012, the Minister of Business and Growth appointed a small group of experts to analyze the reasons for the financial crisis and provide recommendations to reduce the probability and impact of renewed crises. The English summary of the report issued by the Commission, published in September 2013, can be found here: <http://www.evm.dk/english/publications/2013/18-09-13-the-financial-crisis-in-denmark>.

<sup>3</sup> See Technical Note on Macroprudential Policies.

<sup>4</sup> The Danish government's decision on voluntary participation in the Banking Union is pending further analysis of the pros and cons thereof, as well as legal clarifications. Also, see the DN's Financial Stability Report for the first half of 2014 for a description of the Banking Union components here: [http://www.nationalbanken.dk/en/publications/Documents/2014/06/DN\\_Financial\\_stability\\_1\\_half\\_2014.pdf](http://www.nationalbanken.dk/en/publications/Documents/2014/06/DN_Financial_stability_1_half_2014.pdf).

## INSTITUTIONAL FRAMEWORK

*A robust institutional framework is paramount to effective crisis management and bank resolution. At minimum, such a framework should provide for clear mandates for the institutions involved, a distinct allocation of tasks and responsibilities across institutions, and explicit coordination mechanisms, including a solid legal basis for the exchange of confidential information in times of distress.*

### A. Domestic Arrangements

**6. The resolution powers in the current regime are largely allocated to the FSC.** The Financial Business Act provides the DFSA with certain powers to deal with a bank in distress. However, the DFSA has to seek a mandate from the MoBG, on a case-by-case basis, to be able to act beyond its normal supervisory tasks following its determination of the need to intervene in a resolution of a bank. While the DFSA initiates the resolution process via the enforcement of minimum capital requirements, the transfer of the assets and parts of the liabilities of the bank to the FSC depends on a decision made by the bank's management. Moreover, the FSC also has some resolution powers in the context of the transfer of the bank's assets and part of the liabilities under Bank Package III, namely to establish bridge banks and exercise bail-in.

**7. Going forward, the authorities should designate and empower a resolution authority.** In line with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes), the authorities are encouraged to designate a designated administrative authority (or authorities) responsible for exercising resolution powers over firms within the scope of the resolution regime. Where multiple authorities are designated, roles and responsibilities should be clearly defined, with the authorities identifying a lead authority that coordinates resolution actions across different entities of the same group within Denmark. The designated resolution authority (authorities) should have:

- A sufficiently broad **mandate** with a focus on financial stability, including adequate resolution powers, as part of its statutory objectives and functions. In coordination with the relevant insurance schemes, the resolution authority should protect depositors, avoid unnecessary destruction of value, and seek to minimize the overall costs of resolution. Further, the resolution authority should duly consider the potential impact of its resolution actions on financial stability in other jurisdictions;
- **Operational independence**, including safeguards against undue political or industry influence that would compromise its ability to obtain or deploy the resources needed to carry out its mandate and achieve an effective resolution;
- A **robust governance** structure that defines the responsibilities, authorities, and accountability of its governing body and senior management; promotes sound decision-making and effective control and oversight of personnel, including via (i) rules and procedures for the appointment and dismissal of the head of the authority, members of the

governing body (where relevant) and senior management; and (ii) a code of conduct, including rules on conflicts of interest;

- Adequate **resources** (or at least the ability to quickly ramp up resources whenever necessary) and sufficient operating funds to attract and retain staff with sufficient expertise, and in sufficient numbers, to carry out its functions and to commission outside experts to the extent necessary to fulfill its tasks; and
- Rigorous **evaluation and accountability mechanisms** that include procedures for reviewing and evaluating actions that the resolution authority takes in carrying out its statutory responsibilities.

Moreover, the resolution authority and its staff should be protected against liability for actions taken and omissions made while discharging their duties in good faith.

**8. Following the designation of the resolution authority, the roles of the other agencies involved in crisis management should be fine-tuned.** In addition to the DFSA and the FSC, the current institutional set-up for resolution involves several other agencies, namely the Ministry of Business and Growth (MoBG), DN, and the Danish DGS. As part of the transposition of the BRRD,<sup>5</sup> the allocation of responsibilities between the different agencies involved in crisis management and bank resolution should be reconfirmed, together with their respective mandates and roles. Box 2 summarizes the current powers and responsibilities of the key institutions.

**9. The overall legal underpinning for information exchange between the relevant national agencies was strengthened, but bilateral coordination arrangements would benefit from further enhancement.** The law was amended during the crisis to allow for the DFSA to provide confidential information to authorities involved in attempts to save a limited company in critical difficulty, provided that that the recipient adequately safeguards the confidentiality of the received information.<sup>6</sup> Furthermore and more specifically,

- **DFSA and DN.** The DN and the DFSA have a strong tradition of close cooperation, and the management Boards of the two institutions meet on a quarterly basis. Moreover, the DN Act expressly provides for the sharing of information between the DN and the prudential supervisors.<sup>7</sup> In the same vein, a formal agreement was signed between the DFSA and the DN in 2010 for the purpose of accessing information on a regular basis.
- **DFSA and FSC.** The DFSA provides the FSC with information regarding a failing bank as soon as the DFSA receives a mandate from the MoBG to intervene in the resolution of such bank,

<sup>5</sup> Directive 2014/59/EU of May 15, 2014. See: [http://ec.europa.eu/internal\\_market/bank/crisis\\_management/index\\_en.htm](http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm).

<sup>6</sup> Article 354 (6) (10) of the Financial Business Act.

<sup>7</sup> Section 20 of the Danmarks Nationalbank Act.

and based on Article 345 (6) (10) of the Financial Business Act. The mission recommends establishing a formal procedure and operational guidelines on the provision of such information to the FSC.

- **DFSA and the DGS.** The DFSA supervises the DGS and both entities can request information from the DGS contributors, depositors, and investors to ensure compliance with the Guarantee Fund for Depositors and Investors Act. While the DFSA and the DGS de facto coordinate and exchange information when necessary, the legal framework does not expressly provide for information sharing between the two institutions. The FSC also provides the DGS with relevant information it receives from the DFSA relating to a bank that enters into resolution. The mission recommends including amendments to the law allowing for the exchange of information between the DFSA and the DGS, and putting in place a Memorandum of Understanding (MOU) to formalize the specific details for such sharing of information.

**10. The Danish Coordination Group (DCG) for financial stability served as an effective forum for crisis coordination; however, its role could be expanded to cover crisis preparedness in normal times.** The DCG provided a platform for interagency coordination during the financial crisis, and is currently shifting its focus to high-level discussions on legislative proposals and international developments. The mission encourages the authorities to maintain the DCG as a national forum for the exchange of information and cooperation among the different stakeholders involved in crisis management and bank resolution. In particular, this group could be used as a platform to discuss potential improvement of the crisis management framework, coordinate to undertake crisis-management simulation exercises aimed at testing, and consequently improve crisis preparedness.

## Box 2. Institutional Framework in Denmark

**DN**—The DN is the central bank of Denmark. The DN is responsible for the payment system and grants ELA to banks that are solvent but face liquidity difficulties against adequate collateral. The DN’s mandate includes maintaining a safe and secure currency system in Denmark and facilitating the extension of credit (Section 1 of the DN Act). The DN has two tasks when a failing bank is being wound up, one based on its payment system role and another task as banker to the FSC.

**DFSA**—The DFSA is the prudential supervisor for financial undertakings, including banks and mortgage-credit institutions. Pursuant to the Financial Business Act, the DFSA licenses, regulates, and supervises financial undertakings. It has early intervention powers vis-a-vis banks and is responsible for initiating resolution.

**FSC**—The FSC was recently established in 2008 as a limited company owned by the Danish government with a role to resolve failing banks by transferring their assets and part of their liabilities, either to subsidiaries it specifically creates for this purpose (bridge bank) or to third-party buyers, while winding-up the nontransferable liabilities (share capital and subordinated debt).

**MoBG**—The MoBG sets the policy framework for crisis management and bank resolution and provides the DFSA with a specific mandate, on a case-by case basis, to intervene in the resolution of a failing bank. The MoBG has various powers pursuant to the Financial Business Act (e.g., approves mergers of banks), which mostly have been delegated to the DFSA. It is the designated macroprudential authority for the purpose of the CRR/CRDIV implementation and participates in the DCG and the Systemic Risk Council. The MoBG also issues the executive orders, rules, and regulations for the implementation of the Financial Stability Act and the Financial Business Act.

**DGS**—The Danish DGS is a private self-governing institution. The primary mandate of the DGS is to provide depositor payout in case of bank failures. Moreover, pursuant to the Guarantee Fund for Depositors and Investors Act, it provides the FSC with a guarantee against losses the latter incurs following the recapitalization of the subsidiaries (bridge banks) or to cover losses incurred by the subsidiaries as a result of the winding up (funds are provided by the separate Winding-up Department, financed via ex post contributions from the industry). The DGS also gives a loss guarantee to the bridge bank and could decide to provide an acquiring bank with cash injection to cover expected losses resulting from a transfer of assets and liabilities transaction with a failing bank (referred to by the authorities as “a dowry”).

**DCG**—The DCG for financial stability, established in 2005, is a high-level coordination committee comprised of representatives from the DFSA, the DN, the MoBG, the Ministry of Finance (MoF), and the Ministry for Economic Affairs and Interior. It served as a forum for intensive discussions during the crisis, which led to the issuance of the different bank packages, including the current resolution regime. It is not a decision-making body.

## B. Cross-Border Coordination

**11. The current framework for cross-border coordination is broadly appropriate vis-à-vis regional peers, but could benefit from issue-specific enhancements.** Denmark’s banking sector has close regional ties and hosts Nordea, one of the designated global systemically important financial institutions (G-SIFI). This calls for close coordination and cooperation among the Danish authorities and their foreign peers throughout the life cycle of the cross-border banks. The cross-border coordination framework encompasses the following:

- **MOUs.** Cross-border coordination at the regional level on crisis management and bank resolution is guided by the Nordic-Baltic Cooperation Agreement on Cross-Border Financial

Stability,<sup>8</sup> crisis management, and resolution, signed in 2010 between central banks, financial supervisory authorities, and relevant ministries. The Agreement provided a preliminary framework for the sharing of costs associated with jointly agreed crisis management actions, based on (a) the relative importance of the financial group's activities in the respective countries (as measured based on the distribution of assets) and (b) the supervisory responsibilities for the same institution in the same countries. Moreover, it established a formal basis for the Nordic-Baltic Cross-Border Stability Group, which has a mandate to, inter alia, identify (perceived) impediments for coordinated decision making, facilitate information sharing on a cross-border basis, and consider joint approaches for managing crises. The DFSA, the MOBG and the DN participate in this group, since several large Danish banks are either subsidiaries of banks incorporated in Nordic and Baltic countries or have subsidiaries in the latter countries.

- **Supervisory colleges:** As host authority, the DFSA participates in the supervisory college set up by the Swedish supervisory authority to facilitate the effective supervision of Nordea Group. Also, the DFSA, as home authority, has established a supervisory college for Danske Group, which has extensive cross-border operations.
- **Crisis Management Groups (CMG):** The DFSA participates in a CMG for Nordea as a key host authority. The authorities are encouraged to establish CMGs for Danish SIBs with foreign subsidiaries (in particular for Danske) in order to prepare for and facilitate a cross-border resolution, including discussing strategies to resolve such banks ("single point of entry" or "multiple point of entry" approach). Box 3 highlights the progress in developing strategies for the resolution process based on the single point of entry (SPE) and multiple point of entry (MPE) approaches.<sup>9</sup>
- **Institution-specific, cross-border cooperation agreements (COAG):** Firm-specific resolution colleges for systemically important firms with foreign activities should be established to foster effective bank resolution on a cross-border basis. The authorities have not yet signed any COAG; however, discussions in this regard with the Swedish supervisory authorities in relation to Nordea Group have been initiated.

## 12. The authorities could take advantage of the current effective regional cross-border coordination mechanism to further foster harmonization of cross-border resolution issues.

Foremost, the resolution framework, including the resolution toolkit, will need to be harmonized to the extent possible in the Nordic-Baltic region. The transposition of the BRRD will push for a harmonization, to a large extent, of the resolution powers and tools that would be available to resolve a failing bank. However, the authorities are encouraged to coordinate with their regional

<sup>8</sup> [http://www.nationalbanken.dk/en/about\\_danmarks\\_nationalbank/Memorandum%20of\\_Understanding/Documents/MoU\\_EN\\_170810.pdf#search=Nordic%2DBaltic%20Cooperation%20Agreement%20on%20Cross%2DBorder%20Financial%20Stability](http://www.nationalbanken.dk/en/about_danmarks_nationalbank/Memorandum%20of_Understanding/Documents/MoU_EN_170810.pdf#search=Nordic%2DBaltic%20Cooperation%20Agreement%20on%20Cross%2DBorder%20Financial%20Stability).

<sup>9</sup> IMF, "Cross-Border Bank Resolution: Recent Developments," June 2014. <http://www.imf.org/external/np/pp/eng/2014/060214.pdf>.

peers on the requirements for the application of, for example, bail-in powers.<sup>10</sup> Moreover, the framework should provide for transparent and expedited mechanisms that would enable giving effect to foreign resolution measures, either by way of a mutual recognition process or by taking measures that support, and are consistent with, the resolution measures taken by the foreign resolution authority. To this end, the current Nordic-Baltic coordination setup serves as an appropriate forum for cooperation on regional resolution matters. Furthermore, it is important to note that the Danish legal framework does not discriminate against creditors on the basis of their nationality.

### Box 3. Institution-Specific Resolution Strategies

**Progress in developing operational strategies for the resolution of G-SIFIs has focused on two approaches: single and multiple points of entry (SPE and MPE).** These strategies apply to financial groups in their entirety, which may consist of hundreds of different legal entities located in multiple jurisdictions, and give the lead in resolution to the home authority under SPE, and to individual home and host authorities under MPE. Losses of the institution in resolution will accrue and be managed at the parent level under SPE, or at the parent and subsidiary levels under MPE. Both approaches can imply the use of a range of resolution powers, including bail-in, which plays a central role particularly in SPE approaches.

- Under **SPE strategies**, resolution occurs at the very top of the financial group while operating parts of the group are preserved. The home resolution authority intervenes and restructures the holding company that sits at the top of the financial group without the need for host authorities to resolve operating subsidiaries under their respective control. Shareholders and creditors of the apex institution absorb losses of the entire group through a write-down or restructuring of their equity and/or debt claims against the apex entity. Capital freed up from this exercise is “passed down” to loss-making operating subsidiaries and used to recapitalize and provide liquidity for such subsidiaries. SPE requires the ability to downstream loss-absorbing capacity to other parts of the group; and the capacity and willingness to provide liquidity support in resolution—both of which require a high level of cooperation and trust among authorities during resolution.
- Under **MPE strategies**, operating affiliates are resolved separately in different jurisdictions by the respective resolution authorities. Individual parts of the group are resolved in separate proceedings and losses are dealt with at the subsidiary level. Given the risks of disruption and inadequately coordinated actions, MPE requires extensive preparation and coordination to facilitate orderly resolution and preserve essential services and financial functions.
- **Hybrid strategies** are possible—for example, core operations in key jurisdictions where the G-SIFI is active might be resolved under SPE, while stand-alone operations in other countries are resolved following an MPE approach, or closely linked regional operations might be resolved as a group, in an overall MPE strategy.

**The choice of resolution strategy and the structure of cross-border banks must be consistent.** MPE approaches can work well where operating entities can operate on a stand-alone basis. Arrangements need to be made in order to ensure that critical financial and operational services provided by other parts of the group can be reproduced and that adequate loss-absorbing capacity exists locally. Where intra-group operations are more intensively inter-linked, or operations benefit from the size and liquidity provided by a “global” balance sheet (some capital market activity, for example), an SPE approach may be warranted. Recovery and Resolution Plans (RRP) can help develop a picture of where losses might fall or liquidity needs arise in a crisis, providing input for cross-border dialogue on burden sharing and appropriate resolution strategies.

<sup>10</sup> Article 45 of the BRRD.



## CRISIS PREPAREDNESS

*Experience indicates that inadequate crisis preparation can greatly impair authorities' ability to intervene decisively in response to an emerging crisis. Recurrent crisis-management simulations offer an excellent opportunity to test existing procedures and scenarios, while the development of ex ante recovery and resolution plans allow authorities to hone their strategies for dealing with systemically important firms that face severe distress.*

**13. Recovery and resolution planning has evolved into a key component of effective crisis management frameworks.** The concept of RRP (also known as 'living wills') was articulated in early-2009 by the Financial Stability Board's (FSB) predecessor, the Financial Stability Forum.<sup>11</sup> Annex 3 of the Key Attributes, issued in November 2011, provided a detailed overview of essential elements of RRP, and various country authorities subsequently have issued detailed requirements and guidance in this area.<sup>12</sup> In the European Union, the requirement to prepare RRP has been included in the revised Capital Requirements Directive (CRD)<sup>13</sup> as well as in the BRRD. In parallel, the European Banking Authority (EBA) has issued a recommendation on the preparation of recovery plans, supplemented by various consultation papers.<sup>14</sup>

**14. The preparation of recovery plans by Danish banks is in train.** Following the recommendations of the Committee on Systemically Important Financial Institutions in Denmark (Box 4),<sup>15</sup> the DFSA has issued an Executive Order on the Preparation of Recovery Plans, applicable to banks, mortgage credit institutions (MCI), and certain investment firms with assets of DKK 1 billion or more.<sup>16</sup> As per the Executive Order, recovery plans should contain a description of:

- Capital and liquidity measures to be implemented in order to enable the recovery of the firm;
- The firm's critical functions and measures to maintain these in case of distress;
- Strategies to reduce risk-weighted assets, including via disposal of activities; and
- A list of possible merger partners.

<sup>11</sup> [http://www.financialstabilityboard.org/publications/r\\_0904c.htm](http://www.financialstabilityboard.org/publications/r_0904c.htm).

<sup>12</sup> See, for example, <http://www.bankofengland.co.uk/pr/Pages/publications/recoveryresolution.aspx> and <http://www.federalreserve.gov/bankinforeg/resolution-plans.htm>.

<sup>13</sup> Directive 2013/36/EU of June 26, 2013. See [http://ec.europa.eu/internal\\_market/bank/regcapital/legislation\\_in\\_force\\_en.htm#maincontentSec1](http://ec.europa.eu/internal_market/bank/regcapital/legislation_in_force_en.htm#maincontentSec1).

<sup>14</sup> Recommendation on the development of recovery plans, EBA/REC/2013/02 of January 23, 2013. See <https://www.eba.europa.eu/regulation-and-policy/recovery-and-resolution/recommendation-on-the-development-of-recovery-plans>.

<sup>15</sup> The Committee's report was published by the MoBG on March 14, 2013. The English summary can be found here: <http://www.evm.dk/english/publications/2013/14-03-13-sifi-report-introduction-and-summary>.

<sup>16</sup> Executive Order no. 284 of March 27, 2014. See [https://www.finanstilsynet.dk/~media/Regler-og-praksis/2014/Translated-acts/EO284\\_2014.ashx](https://www.finanstilsynet.dk/~media/Regler-og-praksis/2014/Translated-acts/EO284_2014.ashx).

The Executive Order requires firms to submit their initial plans to the DFSA no later than October 1, 2014. Annual updates are to be submitted by June 30 of each calendar year, unless the total assets of the firm drop below DKK 1 billion.

#### Box 4. Recommendations of the Committee on Systemically Important Financial Institutions in Denmark

In January 2012, the MoBG established the Committee on Systemically Important Financial Institutions (the Committee), tasked with the identification of (a) criteria for the identification of Danish SIFIs; (b) requirements to be imposed on these firms; and (c) options for resolution. In accordance with its Terms of Reference, the Committee focused exclusively on banks and MCIs, and did not consider whether 'nonbanks' could be considered systemically important. The Committee's recommendations, albeit with some modifications, have been incorporated in the political agreement on the regulation of SIFIs that was reached in October 2013 (also known as 'Bank Package VI').

Point of departure of the Committee's work, echoing international consensus on the need to reduce the moral hazard risks that are associated with systemically important firms, was that it is essential to limit the probability of an SIFI failing (by introducing a number of additional requirements) and to ensure that, in the event of a failure, such firms can be resolved without systemic disruption and without exposing taxpayers to losses.

Moreover, the Committee noted that the existing Danish resolution scheme (discussed in Chapter V of this technical note) will generally not suffice for managing failing SIFIs, as the latter warrants mechanisms to ensure the continuity of systemic functions, rather than effect a winding-up of the firm.

The key recommendations of the Committee are as follows:

- **SIFI identification.** SIFIs are identified at a consolidated level on the basis of total assets relative to GDP, loans relative to total loans of the sector, and deposits relative to total deposits of the sector, with one of the three thresholds being sufficient for the classification as SIFI.
- **Additional SIFI buffers.** Maintenance of a Common Equity Tier 1 surcharge between 1 percent and 3.5 percent of risk weighted assets (RWA); as well as a separate crisis management buffer of 5 percent of RWA, consisting of debt that can be converted into Common Equity Tier 1, or written down ('bail in').
- **SIFI recovery and resolution planning.** Preparation of recovery and resolution plans, with recovery plans being launched (at the latest) when the SIFI capital requirement is breached.
- **Crisis management:** Trigger for initiating bank resolution proceedings set at 10.125 percent of total capital (in comparison with 8 percent for non-SIFIs.) The DFSA is allowed to initiate resolution proceedings if the firm is no longer deemed viable.
- **SIFI liquidity requirements.** Implementation of the (short-term) liquidity coverage ratio as of 2015.
- **Expanded resolution toolkit.** Introduction of additional resolution powers with mandatory triggers, providing for the establishment of bridge banks, asset sales, and debt conversion or write-downs.
- **Institutional framework.** Establishment of a resolution authority.
- **Resolution funding.** Establishment of a stability fund as of 2020, financed by Danish SIFIs.

**15. Further work remains to be done to confirm resolvability of all Danish firms in line with BRRD requirements.** To date, the DFSA has interacted with Danske Bank on its recovery plan, employing the (draft) guidelines published by the EBA. In addition, the DFSA, the MOBG and the DN are participating in the CMG for Nordea, established by the Swedish authorities in line with FSB requirements. However, pending BRRD transposition, the preparation of comprehensive resolution plans for Danish (systemically important) banks, as well as resolvability assessments (that seek to evaluate the feasibility and credibility of resolution strategies for a particular firm), has not yet been initiated. As the preparation of the recovery plans progresses and the DFSA gains experience with the assessment thereof, the publication of more detailed guidance should be contemplated, *inter alia*, to foster consistency across Danish peers. Areas where guidance could be particularly useful are the identification of critical functions, resolution triggers, and early warning indicators and stress scenarios.<sup>17</sup>

**16. Explicit powers to address impediments to firms' resolvability should be introduced.** It should be ensured, in line with new BRRD requirements, that the resolution authority has explicit powers to impose, where necessary, measures to address identified impediments to resolvability (e.g., changes to a firm's business practices, structure, or organization with the aim to reduce the complexity and costliness of resolution, including the ability to segregate critical functions in legally and operationally independent entities that can be effectively shielded from group problems). When exercising such powers, close coordination between the prudential supervisor and the resolution authority is warranted, also to ensure that the impact on the soundness and stability of ongoing business is duly taken into account.

**17. Operational readiness for managing crises could usefully be tested via recurrent crisis management simulations.** Experience indicates that inadequate crisis preparation can greatly impair authorities' ability to intervene decisively in response to an emerging crisis. At the height of the crisis, various bank interventions have tested the authorities' crisis preparedness, with all interventions under the existing toolkit being completed successfully within a short timeframe. But as these operational successes age, and new policies and procedures are implemented on the back of the BRRD transposition, recurrent crisis- management simulations followed by meticulous evaluations would offer an excellent opportunity to periodically verify the authorities' operational readiness. The authorities are encouraged to periodically (e.g. on an annual basis) organize simulations involving all public sector stakeholders and all components of the financial sector safety net. In parallel, regional crisis management simulations—leveraging the arrangements put in place around the Nordic-Baltic Coordination Group for Financial Stability—could also be considered, albeit with a lower frequency.

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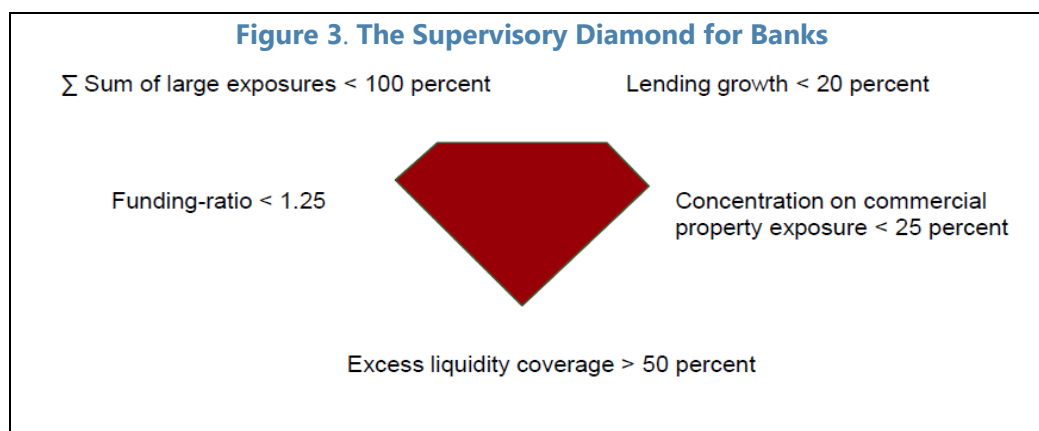
<sup>17</sup> Guidance published by the FSB in July 2013 can serve as a useful benchmark. See [http://www.financialstabilityboard.org/publications/r\\_130716a.htm](http://www.financialstabilityboard.org/publications/r_130716a.htm) and [http://www.financialstabilityboard.org/publications/r\\_130716c.htm](http://www.financialstabilityboard.org/publications/r_130716c.htm).

## EARLY INTERVENTION

*Intrusive supervisory practices can minimize the need for the use of more drastic crisis-management tools. To act as an effective “first line of defense,” the supervisor requires, in particular, (i) a framework for preparing forward-looking assessment of institutions’ risk profiles; (ii) an adequate range of enforcement tools to bring about timely corrective actions and address unsafe and unsound practices; and (iii) independence, legal protection, and adequate resources.*

**18. Intrusive supervisory practices and prompt supervisory intervention can help to minimize the need for the use of more drastic crisis-management tools.** In the run-up to the global financial crisis, supervision in some jurisdictions failed to recognize and/or address growing risks. This failure of supervision was reflected in various forms, including (i) not intruding sufficiently into the affairs of financial institutions, and instead relying on bank management to take appropriate actions and market discipline; (ii) not being sufficiently proactive in dealing with emerging risks and adapting to the changing environment; (iii) not being comprehensive in their scope; and (iv) not taking matters to their conclusion.<sup>18</sup>

**19. The DFSA supervisory framework is highly risk-sensitive.** The DFSA’s regulatory framework places very strong responsibilities on the Board of Directors to have prudent business models and establish effective risk control frameworks. The so-called ‘Supervisory Diamond’ (Figure 3), tracking five ratios that have shown to be indicative of the build-up of risks,<sup>19</sup> is facilitating the identification of firms with a higher risk profile, culminating in the annual update of firm-specific risk assessments that, together with other information sources, feed into the annual inspection program. Stress tests form a key element of the risk assessment, with the DFSA taking the results thereof into account when initiating a dialogue or changing prioritization of on-site inspections.



<sup>18</sup> IMF, “The Making of Good Supervision: Learning to Say ‘No’,” May 2010, <http://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf>.

<sup>19</sup> That is, the sum of large exposures, lending growth, commercial real estate exposures, stable funding and excess liquidity coverage; in each case with threshold ratios having been defined. Noncompliance with the threshold ratios of the Diamond is published on the DFSA’s website.

**20. A comprehensive suite of powers facilitates early intervention by the DFSA.** In recent years, the supervisory powers of the DFSA have been strengthened, including via the introduction of a periodic review of the sustainability of banks' business models. Guidelines on fitness and propriety of banks' management Boards are readily available and the DFSA can require a bank to remove a member of a bank's Board of management if the fitness and propriety of its Board member(s) is no longer within the set criteria,<sup>20</sup> even though the breadth of its fit-and-proper tests do not comprise key managerial positions such as a chief risk officer. Supervisory responses to firm-specific weaknesses are being initiated on the basis of a supervisory ladder that helps to ensure timely and proportional interventions. The various stages of the ladder entail, respectively,

- Intensified surveillance and mandatory disclosure of risk information that may be significant for banks, customers, depositors, other creditors, or (for listed institutions) financial market participants;
- Detailed inspections, conducted by the DFSA, and analyses (to be performed by bank management and signed-off by the external auditor) of the financial circumstances and future prospects of the bank,<sup>21</sup> and
- Corrective actions, to be followed—where such actions are not taken within the time limit specified—by license withdrawal.<sup>22</sup>

**21. Triggers for early intervention are sufficiently flexible.** Corrective actions can be initiated when the financial position of the undertaking has deteriorated to such a degree that the interests of depositors are at risk, or there is a not insignificant risk that, because of the internal and external conditions, the financial position of the undertaking will develop so that the undertaking loses its license. In addition, the DFSA can require a bank that meets minimum capital requirements, but no longer complies with its individual (Pillar II) capital requirements to prepare a capital plan that outlines measures (e.g., capital raisings, reduction of risk-weighted assets, sale of business, etc.) that the institution intends to take to restore its regulatory capital. Implementation of the plan is closely monitored, with the DFSA typically requiring the bank to refrain from paying dividends or coupons on (hybrid) capital instruments. The DFSA has the ability to withdraw the bank's license if the required capital actions are not put into effect within the specified timeframe, or if minimum capital requirements are breached.<sup>23</sup>

**22. Notwithstanding the above, the inspection cycle offers room for improvement.** The BCP assessment conducted as part of the FSAP found that onsite inspections are

<sup>20</sup> Article 351 of the Financial Business Act.

<sup>21</sup> Article 349 of the Financial Business Act.

<sup>22</sup> Article 350 of the Financial Business Act. While corrective actions are not defined in Danish legislation, the DFSA has, for example, ordered a bank to stop granting new loans to a certain category of customers.

<sup>23</sup> Articles 225 and 124 of the Financial Business Act.

comprehensive—involving a thorough and comprehensive assessment of regulatory capital, liquidity, governance, risk management, and Pillar I risks—but also noted that the extended examination schedule limits the immediacy with which issues can be discerned from on-site work and adequate follow-up of key concerns can be ascertained. This is particularly relevant for smaller firms where on-site verification, in the absence of red flags being raised via off-site supervision, can take up to six years.

## CRISIS MANAGEMENT TOOLS

*The tools for crisis management and bank resolution should include solid but flexible arrangements for temporary official financial support of banks, robust resolution powers for banks as a going concern, and a mechanism for orderly liquidation as a gone concern.*

### A. Crisis Containment Measures

**23. The authorities' immediate response to the crisis was prompt and decisive.** Banks' access to funding was ensured through large-scale government guarantees, while recapitalization instruments were made available to buttress banks' regulatory capital positions.

- In October 2008, the Danish government announced a two-year state guarantee covering all depositor claims and other unsecured creditors of banks domiciled in Denmark (Bank Package I). The guarantee, in line with actions taken by other member states, sought to calm funding markets and maintain financial stability. Simultaneously, with the announcement of the guarantees, the authorities established the FSC as a state-owned winding-up company (see Section C). The financial sector was asked to contribute DKK 25 billion as a contribution from the financial sector to the guarantees and the winding-up of distressed firms.<sup>24</sup> The general state guarantee expired on September 30, 2010.<sup>25</sup>
- In January 2009, Bank Package II was adopted, providing for capital support (up to DKK 100 billion in hybrid instruments, allowing institutions to reach a Tier 1 capital ratio of 12 percent) and state-guaranteed debt issuances with a maturity of up to 3 years. Applications for the recapitalization scheme could be submitted until June 30, 2009, while guaranteed debt could be issued up to December 31, 2010. When this package expired, capital injections amounted to approximately DKK 46 billion, distributed among 43 institutions, while debt issuances of 50 institutions totaled DKK 193 billion.

<sup>24</sup> Comprising DKK 15 billion in commissions for the state guarantee and a DKK 10 billion contribution to the costs of winding up distressed firms via the FSC. Bank Package I provided for another contribution of up to DKK 10 billion, if losses incurred by the FSC would exceed DKK 25 billion. This additional loss security was not triggered.

<sup>25</sup> Estimates from the MoBG (<http://www.evm.dk/aktuelt/nyheder/2014/05-03-14-okonomisk-status-paa-bankpakkerne-januar-2014>) indicate that Package I generated an upside of DKK 2.5 billion (computed as the difference between the industry contribution of DKK 25 billion and the aggregate cost of winding-up distressed firms, amounting to DKK 22.5 billion.) As of January 2014, the aggregate windfall for the state of all Bank Packages was estimated at DKK 12.15 billion (about 0.8 percent of GDP.)

**24. The bank packages contained strong safeguards to minimize competitive distortions.** The schemes were temporary and ensured (via enhanced monitoring and a prohibition of mass marketing) that the participating banks would not unduly expand their activities, and, thus, receive more support than necessary for reestablishing their long-term viability. Moreover, the remuneration of the recapitalization instruments was set to reflect market conditions, while simultaneously providing incentives for early reimbursement. Finally, behavior commitments (limitations to the distribution of dividends, ban on share repurchases, and remuneration limits for Board members) sought to reduce the risk of undue distortions of competition and aimed to ensure that beneficiaries did not use capital injections for purposes other than to support lending to the real economy. The schemes were found to be in line with EU state aid rules and were accordingly approved by the European Commission.<sup>26</sup>

## B. Emergency Liquidity Assistance

*The framework for ELA should allow the state or an official agency (in particular the central bank) to provide rapidly, and in a legally robust manner, emergency liquidity to illiquid but solvent banks. The liquidity provider should have tools to manage credit risks, including collateral requirements.*

**25. DN manages the liquidity in the banking system through its monetary policy operations.** Via its ordinary weekly market operations, funding is provided to eligible counterparties via collateralized loans, while excess liquidity is being absorbed through the sale of certificates of deposit. Moreover, liquidity adjusting deposits and lending operations in DKK are being used, as and when needed, to support the fixed exchange rate policy. In October 2011, the DN temporarily expanded its collateral basis, accepting banks' credit claims of good quality as collateral for its monetary policy operations (resulting in an estimated increase of collateral of up to DKK 400 billion); and simultaneously introduced a long-term lending facility, providing eligible counterparties with six-month variable-rate loans on a collateralized basis.<sup>27</sup> The latter exceptional measures, which were taken to further improve banks' funding conditions and ease the eventual phase-out of state-guaranteed funding instruments that were introduced as part of Bank Package II, were fully phased out as of July 1, 2014.<sup>28</sup> Finally, the DN has introduced—in parallel with the introduction of the three-year Longer Term Refinancing Operations made available by the European Central Bank to eligible

<sup>26</sup> See press releases of October 10, 2008 (<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1483>) and February 3, 2009 (<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/206>).

<sup>27</sup> Press release DN September 30, 2011, <http://www.nationalbanken.dk/en/pressroom/Documents/2011/09/DNN201114967.pdf>.

<sup>28</sup> Press release DN December 2, 2013, <http://www.nationalbanken.dk/en/pressroom/Documents/2013/12/DNN201319447.pdf>.

counterparties—a temporary three-year lending facility, maturing in March and September of 2015.<sup>29</sup>

**26. Emergency liquidity assistance (ELA) is an essential supplement to regular monetary policy instrument, to be used in exceptional circumstances.** In short, ELA entails the provision of liquidity in order to mitigate sudden funding pressures that could, if not addressed, undermine financial stability. Under exceptional circumstances, providing ELA may prevent illiquidity at one or more banks from triggering a systemic loss of confidence that spreads to otherwise healthy institutions. During past crises, ELA has proved indispensable to prevent contagion and avoid systemic distress.

**27. The framework for providing ELA, although well-tested, should be further strengthened.** DN’s ability to provide ELA is derived from its broadly formulated mandate to “maintain a safe and secure currency system [...] and to facilitate and regulate the traffic in money and the extension of credit.” During the financial crisis, DN has had to provide ELA on three separate occasions, lastly in 2008, in each case backed by loss guarantees. The authorities are encouraged to strengthen their framework to expressly provide for the DN’s power to grant ELA to solvent but temporary illiquid institutions, subject to adequate collateral. Moreover, since the provision of ELA may have to be effected within a tight timeframe and under stressful circumstances, the preparation of internal guidelines and action plans is highly beneficial. The guidelines should codify, amongst others:

- Eligible counterparties;
- Arrangements for prompt decision-making;
- Assets that the DN would accept as collateral (presuming that collateral for regular refinancing operations will already have been exhausted);
- Guidance on pricing and maturity; and
- Additional conditions that may be imposed on the recipient bank (for example, requirements to reduce its balance sheet, enhanced reporting requirements).

**28. Coordination arrangements between the DN and the DFSA pertaining to ELA should be made explicit.** While the (potential) need for ELA may, in certain circumstances, be anticipated—allowing for advance preparation—sudden shocks may prompt immediate decisions amidst uncertainty on the applicant’s asset quality. It is particularly in the case of the latter that robust coordination arrangements between the DN and DFSA are essential. To be effective, such arrangements should cover both the consultation of the DFSA by the DN at the time of the ELA request, as well as the coordination and information exchange following the

<sup>29</sup> Press release DN December 8, 2011, <http://www.nationalbanken.dk/en/pressroom/Documents/2011/12/DNN201115390.pdf>.



provision of ELA. To reduce the prospect of losses for the DN, ELA recipients should be subjected to intensified supervision—possibly involving continuous on-site presence of DFSA staff to monitor developments—with prompt supervisory action being taken if the recipient bank shows (continued) signs of distress. Such coordination could possibly be formalized by expanding the scope of the current MoU signed between the DN and the DFSA.

**29. When providing ELA, the benefits of disclosing ELA operations should be carefully weighed against financial stability considerations.** In previous cases, DN's participation in ELA operations has been described in its Annual Report and Quarterly Monetary Reviews, while disclosure obligations applicable to recipient banks may require banks to issue press releases. Such degree of transparency, although laudable under normal circumstances, may trigger moral hazard and otherwise prove counterproductive when financial sector confidence is frail. As also recognized by other authorities during the financial crisis,<sup>30</sup> financial stability considerations may justify flexibility in both the timing and content of disclosures pertaining to ELA operations. To the extent necessary, provisions governing disclosure should be changed to allow for such flexibility (possibly, as far as supervised institutions are concerned, subject to prior notification of DFSA).<sup>31</sup>

### C. Resolution Regime

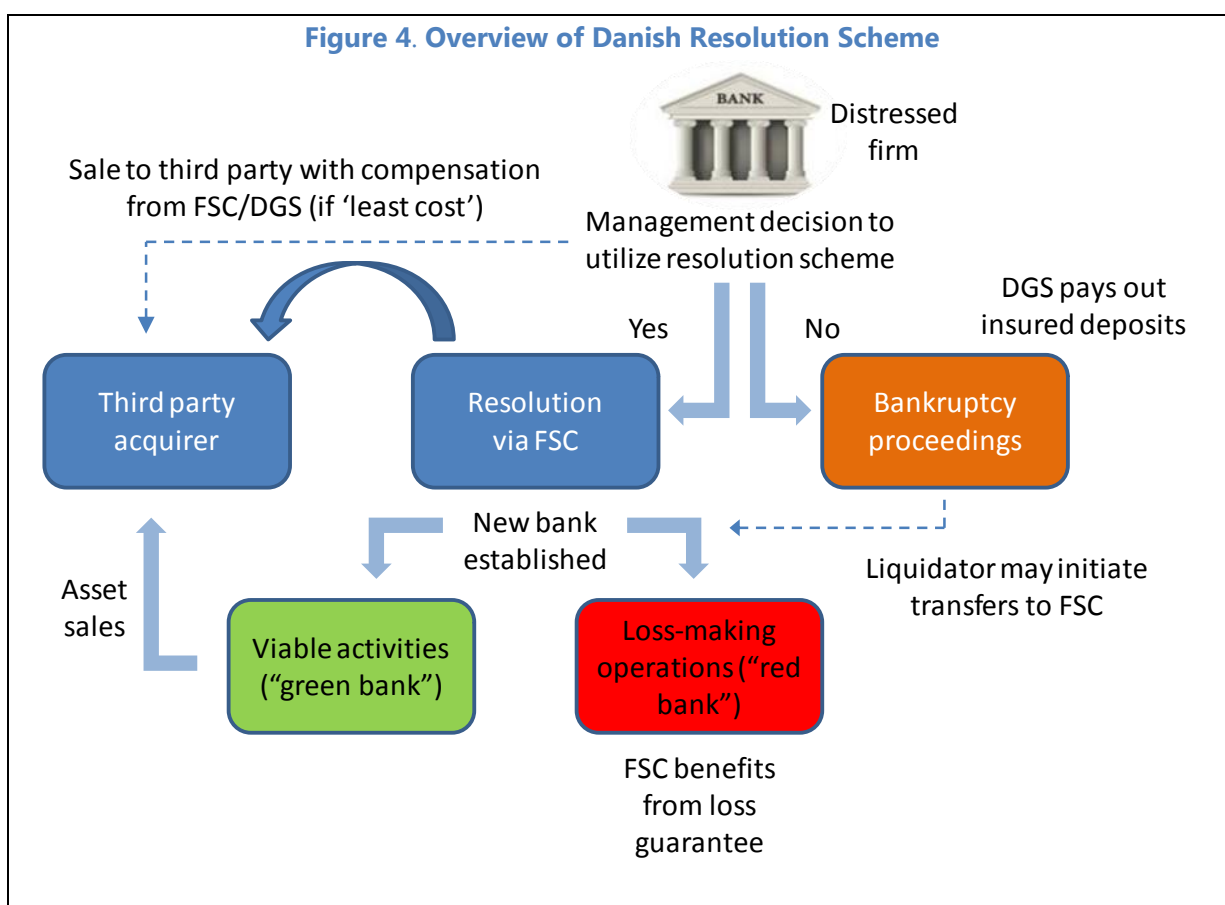
*Effective resolution regimes provide authorities with a broad range of powers that can be initiated on a timely basis, i.e., when a firm is no longer viable, or likely to be no longer viable, and has no reasonable prospects of recovery. The regime should allow for the orderly resolution of all banks, including D-SIBs, and provide for suitable indicators to help guide decisions on entry into resolution. To ensure effectiveness, there should not be any factors that could constrain the implementation, or result in a reversal of resolution actions taken in good faith.*

**30. The Danish resolution framework provides an effective framework for dealing with small- and medium-size distressed firms.** The resolution scheme, introduced in October 2010

<sup>30</sup> See for example, the explanation of the Bank of England on postponing the disclosure of the ELA provided to RBS and HBOS, <http://www.bankofengland.co.uk/publications/Documents/other/treasurycommittee/financialstability/ela091124.pdf>. Moreover, the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (<http://www.imf.org/external/np/mae/mft/Code/index.htm>) explicitly recognizes that "moral hazard, market discipline, and financial market stability considerations may justify limiting both the content and timing of the disclosure of some corrective actions and emergency lending decisions, and information pertaining to market and firm-specific conditions."

<sup>31</sup> Article 27 (6) of the Danish Securities Trading Act provides issuers of securities (admitted to trading on a regulated market in Denmark or the EU) with the possibility to delay, under their own responsibility, the public disclosure of inside information in order not to prejudice their legitimate interests (negotiations where the outcome would be likely affected by public disclosure), provided that such omission would not likely mislead the public and provided they are able to ensure the confidentiality of that information.

through Bank Package III, has allowed the authorities to effectively resolve a number of small- and medium-size distressed firms at minimal cost to the taxpayer. The scheme constitutes an orderly winding up of the affected bank by providing for a transfer of the distressed bank's assets and part of its liabilities to subsidiaries of the FSC (bridge banks) or to third-party acquirers, while winding up the rest of the bank's activities through ordinary liquidation. This resolution scheme allows the FSC to allocate losses to shareholders and holders of subordinated debt of the failing bank, as their claims are left behind in the entity that is to be liquidated. The process is "initiated" by the DFSA if the bank in distress does not meet the capital requirements within the deadline set by the DFSA (Figure 4).



**31. A bank resolution under the scheme, conducted over the course of a weekend, involves the following steps:**

- **Decision to use the scheme.** The scheme is activated via a notification from the management of the distressed bank that, should private sector solutions prove unavailable, it wishes to be wound-up under the scheme.
- **Asset review.** The FSC conducts a preliminary review of the bank's assets, with the aim to determine their minimum realizable value in case of an immediate sale, excluding goodwill. The preliminary transfer value of the assets comprises the sum of the estimated realizable

values. During the valuation process, bank management can continue to pursue private sector solutions.

- **Split of the distressed bank.** Unless a private solution is found, the assets of the failed bank are transferred to a licensed subsidiary of the FSC (“new bank”) that pays the transfer sum by taking over a proportional share of the distressed bank’s nonsubordinated liabilities. Insured deposits suffer no losses (if necessary, resources from the DGS are made available to ensure the availability of their funds), but other unsecured senior creditors face haircuts on their outstanding balance (bail-in). Equity holders and subordinated creditors are kept with the residual entity.
- **“New bank” disposal.** In order for the new bank to continue the operations of the distressed bank, the FSC injects capital and liquidity. The FSC subsequently proceeds to gradually sell transferred assets to third parties. In effecting the winding-up of the “new bank”, FSC aims to maximize recoveries by avoiding fire sales. Any losses incurred by the FSC are absorbed by the banking industry via loss guarantees provided by DGS’ Winding-up and Financial Reconstruction Department. The license of the distressed bank is eventually revoked by the DFSA.
- **Final compensation.** Following the transfer, the final value of the assets is determined by two independent auditors. Depending on the valuation, an additional dividend may be available to nonsecured creditors.

**32. The DFSA does not have the explicit legal power to compel a failing bank to enter into resolution.** The Danish Business Act provides that the resolution of a failing bank can only occur if the latter’s Board of Directors agrees to transfer its assets and part of its liabilities to the FSC. Thus, the ultimate decision to enter into resolution pursuant to the current regime lies with the failing bank’s management. However, the Board of Directors of a failing bank has strong incentives for choosing to enter into resolution rather than bankruptcy, especially in terms of being liable for increased losses. The procedures of the resolution scheme apply notwithstanding the provisions in the bank’s articles of association.

**33. The triggers for the resolution powers should allow for their deployment at an early juncture when the firm is no longer or likely to be no longer viable.** Pursuant to the current legal framework, the breach of capital requirement by a bank, and the non-adherence thereof following a compliance notice by the DFSA, leads to resolution.<sup>32</sup> Moreover, the DFSA may impose individual solvency requirements on banks that are required to submit rehabilitation plans and undertake the necessary measures to ensure compliance with such requirements within a timeframe, following which, in case of noncompliance, the latter will enter into resolution. The authorities are encouraged to provide for further quantitative (objective) and qualitative (subjective and more flexible) resolution triggers in order to allow for the use of the

<sup>32</sup> Article 246 (1) of the Financial Business Act prescribes the breach of the capital adequacy as a quantitative trigger for resolution.

resolution powers before a firm is balance-sheet insolvent and before all equity has been fully wiped out. There should be clear standards or suitable indicators of non-viability to help guide decisions on whether firms meet the conditions for entry into resolution.

**34. The authorities should consider expanding the resolution toolkit.** In addition to the transfer of assets and part of the liabilities of a failing bank under Bank Package III (including the power to establish bridge banks), the resolution authority should have enshrined in the law additional resolution tools to resolve banks, such as by way of forced recapitalization and merger, and appointment of an official administrator to try to restore the bank or part of its activities into viability. Moreover, in addition to the current ability of the FSC to allocate losses to shareholders and holders of subordinated debt (by leaving their claims behind in the entity that is to be liquidated), the FSC (or, if different, the designated resolution authority) should have the power to impose mandatory debt restructuring (bail-in) in a “going concern” resolution, by writing down liabilities and/or converting them to equity in order for the bank to continue operating. To this end, in order for the bail-in tool to be effective, it is necessary to have sufficient debts capable of being bailed-in at the time when a bank is being resolved.

**35. A further wave of specific legal amendments is necessary to enhance the effectiveness of the Danish resolution scheme.** In line with the Key Attributes, the inclusion of additional resolution tools should be complemented with the resolution authority’s right to remove the failing bank’s management (in addition to the DFSA’s early intervention right to remove an “unfit” member of the bank’s Board<sup>33</sup>), and to temporarily impose moratoria and stays on the exercise of contractual rights (such as acceleration, early termination, set-off, and netting rights) that could be triggered by the failing bank’s counterparties once it enters into resolution. The current resolution regime does not grant the DFSA or FSC such powers. Moreover, while the current framework allows the bank’s management to override shareholders’ rights, the resolution authority should have similar powers, which should also be expanded and enforced when imposing other resolution tools by the resolution authority (such as forced mergers and recapitalization), as this is critical to avoid effective resolution being taken hostage by the shareholders, such as the latter blocking these transactions.

**36. The resolution authority should have the power to place a bank in distress under public control via official administration.** Under the present regime, the DFSA can replace Directors who do not comply with the “fit-and-proper” criteria prescribed in the Financial Business Act. However, the law is silent on the ability of the DFSA to appoint “official administrators” to take control of and manage the affected firm. Such administrators would assume the legal powers of the Board of Directors, and shareholders and have the possibility to effectively replace Directors and managers. Their mandate would be to assess the financial situation of the bank, design and implement a rehabilitation plan through the use of resolution tools where possible, and prepare liquidation where impossible. This power to appoint official administrators has proven to be an effective instrument to conserve banks’ assets and stabilize

<sup>33</sup> Article 351 (3) of the Financial Business Act.

operations, notably in situations where the replacement of senior management is deemed to be insufficient to remedy identified weaknesses. In this context, the BRRD<sup>34</sup> envisages the introduction of these administrators to either temporarily replace bank management, or (for the duration of the official administration) oversee bank management via pre-approval rights of specific management decisions.

**37. Official administrators, as agents of the resolution authority, require a broad suite of powers.** Inter alia, these administrators should be able to veto decisions of the bank's corporate bodies, have executive managerial powers, be able to revoke decisions previously adopted by the bank's management, convene the institution's general meeting of shareholders, or, when necessary, take over the powers of the latter. Accordingly, such administrator would take full control of the institution in order to restore it, or parts of its business, to ongoing and sustainable viability. In doing so, official administrators are accountable to the resolution authority, with the latter typically being empowered to provide broad strategic guidance and/or pre-approve certain strategic decisions.

**38. Official administration can be used to facilitate resolution planning.** Official administrators are generally ideally positioned, given their unfettered access to information, to carefully evaluate the bank's condition, the quality of its assets, and its susceptibility to further losses; and gather preparatory information for a subsequent resolution action (notably, a transfer of assets and liabilities to a privately-owned buyer, a bridge bank, or an asset management company). In particular, input from such an administrator can benefit the preparation of a bid package, as well as the design of an appropriate marketing strategy; although care needs to be taken to maintain confidentiality to the maximum extent possible, as untimely disclosure of information that may point to material weaknesses can quickly erode public confidence and further exacerbate the institution's condition.

**39. The recommendations are along the lines of the BRRD.** The mandatory transposition of this Directive by January 1, 2015 allows the Danish authorities to make progress in strengthening the resolution regime. In this regard, the authorities indicated that they are in the process of implementing the new BRRD, a step that will introduce major changes to their current resolution regime.

**40. Legal remedies should not constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith.** In practice, there have never been cases of revocation or suspension of decisions or measures taken by the DFSA or the FSC in applying the resolution scheme. However, the law does not explicitly limit the courts' remedies to monetary damages, leaving open the possibility for the court to halt the implementation of resolution actions or unwind transactions already executed (e.g., transfer of assets and liabilities). Moreover, the decisions of the DFSA to remove banks' Directors based on "fit-and- proper" criteria could be challenged in court, which could

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<sup>34</sup> Article 29 of Directive 2014/59/EU.

lead to a decision by the latter, enabling such Director to retain his position during the legal proceeding.<sup>35</sup> The latter could have serious negative implications on the decision-making process, and possible reputation, of the bank. Moreover, in the context of a transfer of assets and part of the liabilities to the FSC or a third party acquirer, under the resolution regime (Bank Package III), the valuation of the bank could be tested by the courts through a lawsuit initiated within no later than three months after receiving such valuation.<sup>36</sup> Targeted legal amendments will be necessary to limit the scope of legal remedies to monetary compensation, subject to “no creditor worse off than in liquidation” test.<sup>37</sup>

## D. Funding of Firms in Resolution

*Jurisdictions should have arrangements in place to provide (temporary) financing to facilitate the effective implementation of a chosen resolution strategy. Any provision of temporary public support should be subject to strict conditionality to minimize the risk of moral hazard.*

**41. Funding arrangements fulfill an essential function in effective bank resolution regimes.** Resolution authorities may require funding at different stages in the resolution process, inter alia to provide liquidity to firms under liquidation, bridge banks, or asset management companies; capitalize bridge banks; and contribute resources to facilitate a transfer of (insured) deposits (subject to a “least cost” test). While cross-country experiences point to significant variation in design modalities, the notion that it is the banking industry, rather than the taxpayer, that should, ultimately, shoulder the burden of resolution, is widely accepted among international standards setters and senior policy makers. In this context, two stylized options can be distinguished, i.e., (i) the creation of resolution funds, financed via ex ante contributions from the industry (similar to many DGS); and (ii) the use of public resources, with the ability to recoup any outlays from the industry on an ex post basis on the need for credible funding arrangements.<sup>38</sup>

**42. The Danish resolution scheme comprises a mix of public and private funding elements.** On the one hand, Bank Package IV allows the Banking Department of the DGS, which benefits from ex ante financing, to contribute resources to resolution actions (subject to certain restrictions); while the loss guarantees that the FSC receives from the DGS’ Winding-up Department de facto allows for the allocation of losses to the industry on an ex post basis. On

<sup>35</sup> Article 351(5) of the Financial Business Act.

<sup>36</sup> Section 16g, subsection (10) of the Financial Stability Act.

<sup>37</sup> Key Attribute 5.2: “Creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable solvency regime (“no creditor worse off than in liquidation” safeguard).”

<sup>38</sup> Germany and Sweden, for example, have opted for resolution funds that are gradually being build up via industry levies, while the United States has decided to provide the FDIC, its resolution authority, with a credit line from the treasury, subject to certain restrictions, and the ability to impose levies on the industry if recoveries from the distressed firm’s assets are insufficient to repay the treasury. Also see Key Attribute 6.

the other hand, the FSC has unlimited access to the Danish government's re-lending facility,<sup>39</sup> allowing the FSC to raise loans directly from the government, with the terms and conditions thereof in essence, mirroring those of (domestic) government bonds.<sup>40</sup> Using the re-lending facility, the FSC is able to mobilize resources to provide capital and liquidity, to the extent necessary, to its subsidiaries. As the unwinding of the acquired assets and liabilities progresses, excess capital and liquidity is returned to the government via reimbursement of the loans.

**43. Going forward, the authorities are recommended to consolidate funding arrangements via a robust resolution fund.** In line with BRRD requirements, the fund should be gradually built up via industry contributions; have the power to impose extraordinary contributions on the industry; and benefit from a robust public backstop, to be tapped in situations where available resources are insufficient to meet financing needs associated with resolution actions. The fund's target level and industry contributions will have to be carefully determined, taking into account potential outlays (factoring in the characteristics of the financial sector).<sup>41</sup> Given the size of the Danish banking system in comparison to GDP, the authorities may want to set a target level that exceeds the minimum requirement under the BRRD of 1 percent of the covered deposits for the entire banking system. To incentivize institutions to reduce their contribution to systemic risk, contributions should eventually be risk-adjusted, but setting a flat rate for the first few years would ease implementation. To avoid overburdening the banking system, a reasonable phase-in period (e.g., 5 to 10 years) will be required.

## E. Bank Liquidation and Insolvency

*Authorities should develop procedures that allow for liquidating banks in an orderly manner. This involves rapidly transferring insured deposits and critical banking functions (payment services, trade finance) out of the insolvent estate before the remainder is liquidated in the traditional fashion. Thus, those critical elements continue to operate in going concern, while the remainder of the failed bank is liquidated and removed from the market.*

**44. The liquidation of banks is governed by the general insolvency regime, albeit with exceptions to address the specific nature of banks and MCIs.** Pursuant to the Danish Bankruptcy Act, banks and MCIs are not excluded from ordinary insolvency proceedings. The law provides that a debtor is considered insolvent when it is unable to meet its liabilities as they become due, unless its inability to pay is deemed temporary.<sup>42</sup> The latter is considered

<sup>39</sup> Article 3(3) of the Financial Stability Act.

<sup>40</sup> See [http://www.nationalbanken.dk/en/governmentdebt/centralgovernment\\_debt/Pages/Government-Guarantees-and-Re-lending.aspx](http://www.nationalbanken.dk/en/governmentdebt/centralgovernment_debt/Pages/Government-Guarantees-and-Re-lending.aspx).

<sup>41</sup> One potential benchmark for "rightsizing" a resolution fund—the average fiscal cost of government interventions during the financial crisis, net of recoveries, for advanced G-20 countries—points to a financing need of just below 3 percent of GDP. See IMF, "A Fair and Substantial Contribution by the Financial Sector," June 2010, <http://www.imf.org/external/np/g20/pdf/062710b.pdf>.

<sup>42</sup> Article 17 (2) of the Danish Bankruptcy Act.

inappropriate when applied to banks, since the unique features of their business require an earlier intervention before the bank is actually insolvent. Therefore, the Danish Financial Business Act provides for special derogating provisions in case of bankruptcy of these entities.

- **Amended insolvency definition.** The Financial Business Act considers banks insolvent when they are unable to meet their obligations regarding subordinated capital taken up as hybrid core capital or subordinated loan capital, accordingly providing for an earlier threshold for placing a bank under liquidation.
- **Appointment bankruptcy trustee.** The law provides for prior consultation of the DFSA before the bankruptcy trustee is appointed by the bankruptcy court, and while de jure, the DFSA's opinion is not binding, it has always been taken into consideration— something the mission recommends enshrining in the law.<sup>43</sup>
- **Transfers to the FSC.** Bankruptcy trustees of banks are empowered to enter into an agreement to transfer all the assets and part of the liabilities of the bankrupt bank to the FSC by applying mutatis mutandis the resolution measures under Bank Package III.<sup>44</sup>

**45. While the liquidation procedure comprises features that are useful in liquidating banks in an orderly fashion, further strengthening of the framework is encouraged.** In this regard, the supervisory and resolution authorities should have special powers to coordinate with the bankruptcy courts and the trustees. These authorities would provide the trustees with the necessary details, guidance, and recommendations on the liquidation of insolvent banks to ensure that they are well informed of the latter's situations (strengths and weaknesses of the liquidated bank) and on any potential acquirers of these banks.

**46. The legal framework does not provide depositors with preferential claims on the assets of a failed bank.** Under the current legal framework,<sup>45</sup> all creditors, including insured depositors, rank *pari passu* with other unsecured creditors, thus not providing preferential treatment for depositors' claims on the assets of a failed bank. Moreover, while the DGS law includes the right of subrogation for the DGS when payouts are made to eligible depositors, similar to depositors, the DGS is treated like other creditors.

**47. The introduction of depositor preference offers certain advantages.** Depositor preference, in its most simple form, provides "eligible" depositors with preferential treatment vis-à-vis other unsecured creditors (Box 5)—thus, enhancing depositor confidence by reducing the likelihood of losses. The latter being more visible when the depositor preference takes the form of general or tiered depositor preference. Moreover, depositor preference, in combination with a

<sup>43</sup> Article 234 (3) of the Financial Business Act.

<sup>44</sup> Articles 8(2) and 7(2) of the Financial Stability Act.

<sup>45</sup> The Bankruptcy Act governs the ranking of claims. Preferential claims include those arising during, or in connection with, the administration of the bankruptcy estate, all employee claims and those related to income tax, certain suppliers' claims, i.e., claims for duties on dutiable goods, and finally unsecured claims.



subrogation of insured depositors' rights to the DGS upon a reimbursement of insured deposits, can help reduce the costs of resolution for the DGS and maximize its recoveries on the assets of the failed bank. At the same, however, the introduction of depositor preference may negatively impact bank funding costs or the availability of unsecured wholesale funding.

### Box 5. Different Forms of Depositor Preference

**Depositor preference is attracting renewed interest in the aftermath of the crisis.** A significant number of jurisdictions (e.g., Australia, India, Hong Kong, Indonesia, Russia, Singapore, Switzerland, and the United States) already afford preferential treatment to at least some depositors, and similar reforms were recently introduced in the United Kingdom and the European Union.

**Cross-country experience points to three distinct forms of depositor preference:**

- *Insured depositor preference* provides preferential treatment for insured depositors (and the DGS through subrogation) and ranks uninsured deposits pari passu with senior unsecured creditors.
- *General depositor preference* provides preferential status to all deposits, including those above the DGS' insurance limit. The DGS is subrogated for insured deposits and ranks pari passu with uninsured depositors.
- *Tiered depositor preference* prefers insured deposits (and the DGS through subrogation) over uninsured deposits, and prefers both over senior unsecured creditors.

**The BRRD provides for preferential treatment of deposits in insolvency proceedings, in the form of tiered depositor preference.** As such, (i) covered deposits and the DGS (subrogated to the rights and obligations of covered depositors in insolvency proceedings), are given priority on the assets of the failing bank; and (ii) subsequently, eligible deposits from natural persons and micro, small, and medium-sized enterprises which exceed the coverage level are given priority over claims of ordinary unsecured, non-preferred creditors.

**Implications of depositor preference for cross-border coordination should be carefully analyzed.** Material differences in the creditor hierarchy between home and host countries may negatively affect cross-border cooperation in matters pertaining to bank resolution. For example, a territorial limit on depositor preference would provide domestic depositors with a preferred claim on the assets of a foreign branch of that same bank, possibly prompting host authorities to take ring-fencing measures to better protect local depositors.

### Box 5. Different Forms of Depositor Preference (concluded)

<i>Pari Passu</i>	Insured DP	General DP	Tiered DP
All depositors (and subrogated DGS) and other senior unsecured creditors rank <i>pari passu</i>	DGS (subrogated for insured deposits)	All deposits (with DGS subrogated for insured deposits)	DGS (subrogated for insured deposits)
	Other senior unsecured (including uninsured depositors)		Eligible deposits over deposit insurance limit
		Other senior unsecured	Other senior unsecured

Note: a higher position in the table and darker shading (within the same column) indicates a higher creditor claim.

**48. Creating clear legal grounds for the preferential treatment of depositors over other unsecured senior creditors can facilitate bank resolution.** Applying certain resolution tools outside liquidation might impose losses on the creditors of a failing bank, which could be in the same or different order and magnitude than in liquidation. The introduction of depositor preference would facilitate the resolution process by avoiding legal challenges from other unsecured creditors through the establishment of clear legal grounds for the preferential treatment of depositors, in particular in case of a transfer of deposits as a bank resolution technique. Also, the latter would, arguably, help maximize market discipline as a larger loss exposure for unsecured creditors provides strong incentives to monitor banks' risk-taking behavior more closely. In the same vein, for the depositor preference to be effective, there must be sufficient unsecured liabilities to absorb the bank's losses.

**49. Current legislation provides important safeguards for the orderly liquidation of MCIs.** In contrast with banks, MCIs have no depositors that warrant immediate protection in case of a failure. This, in combination with the fact that the issue of a bankruptcy order against an MCI does not, as per the Mortgage-Credit Act, give rise to any early repayment of the bonds and derivative contracts,<sup>46</sup> means that MCIs are, in essence, hardened against runs that could destabilize traditional banks. Hence, the legal provisions governing the bankruptcy of an MCI assume continued performance, to the extent possible, of the MCI's obligations by a liquidator, with the distressed MCIs being wound-up in accordance with the repayment schedule of the underlying mortgage loans. To facilitate such a process, the Mortgage-Credit Act provides the liquidator with the ability to raise additional loans (e.g., via the issuance of junior covered bonds, secured by the asset pool but subordinated to other bonds), refinance maturing bonds and provide additional collateral (e.g., in situations where adverse movements in the value of the

<sup>46</sup> Article 28(1) of the Mortgage-Credit Act.

collateral trigger a need to provide supplementary collateral<sup>47</sup>). The recent amendments of the Mortgage-Credit Act on the mandatory maturity extension of the bonds in case of a failed refinancing of short-term bonds<sup>48</sup> seek to provide a safeguard against severe funding pressures that may otherwise arise—the probability of which is higher in a liquidation scenario than in a going-concern setting, with the bonds being issued by a healthy institution with strong capital buffers. There are no practical experiences with the bankruptcy regime for MCI.

**50. Notwithstanding the legal possibility of a gradual winding-up, the authorities should contemplate alternatives for dealing with distressed MCIs.** The aforementioned gradual wind-up, although legally feasible, presents a number of drawbacks that may make this strategy impractical, and hence, point to the need for the development of alternative strategies, to be activated at an earlier stage, e.g., involving early intervention powers of via the transfer of covered pools, together with the affiliated bonds, to a healthy institution or a (going-concern) bridge bank. Moreover, the appointment of an official administrator could prove useful.

- First, the Danish covered bond market is highly concentrated among issues, with the two largest MCIs accounting for more than 70 percent. Due to this concentration, distress of one MCI can easily spillover to others, as investors may perceive the distress as being reflective of broader market vulnerabilities. To maintain investor confidence, early interventions that would seek to prevent the entering into formal bankruptcy proceedings are inherently advantageous.
- Second, the failure of one of the larger MCIs will have a significant impact on the availability of mortgage financing in the Danish economy. In this context, resolution of an MCI should first and foremost be geared toward going-concern solutions.<sup>49</sup>
- Third, activation of the mandatory maturity extensions, intended to absorb immediate funding pressures, may have a pro-cyclical effect, as the prospect of a maturity extension can trigger price declines as some investors attempt to exit the market before the extension is activated. This, in turn, would affect Danish financial institutions holding similar bonds, who may decide to reduce their holdings.<sup>50</sup>

<sup>47</sup> Article 33d of the Mortgage-Credit Act.

<sup>48</sup> The amendment allows for an extension of the maturities of the bonds by one year if there (a) is insufficient demand or (b) interest rates increase by more than 5 percentage points. If an auction fails in the situation of bankruptcy, the bonds will be altered to a long-dated, fixed-rate instrument, with the term and installments corresponding with the underlying mortgage. See <http://www.evm.dk/english/news/2013/28-11-13-safeguarding-the-danish-mortgage-credit-model>.

<sup>49</sup> As per the FSB's KA, the objective of effective resolution regimes is to "allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, **while maintaining continuity of their vital economic functions.**"

<sup>50</sup> See Technical Note on Systemic Issues in Mortgage Loans and Covered Bond Finance.

- Finally, the ability to wind up the covered pool in accordance with the repayment schedule of the underlying loans assumes that the liquidator (which, ideally, should involve a financial expert, in addition to the mandatory appointment of a lawyer as liquidator) will need to maintain servicing capabilities for a prolonged period, at a time when qualified staff will have a strong incentive to find employment elsewhere. Such a scenario poses operational risks and may impose additional liquidation costs on the bankruptcy estate.

## DEPOSIT GUARANTEE SCHEME

*DGS seek to promote public confidence by clarifying the authority's obligations to depositors (or if it is a private system, its members), and limiting the scope for discretionary decisions. Moreover, DGS can help to contain the costs of resolving failed banks, and can provide countries with an orderly process for dealing with bank failures and a mechanism for banks to fund the cost of failures.*

**51. The Danish DGS is organized as a private, self-governing institution established by an act of parliament and subject to supervision by the Danish FSA.** The DGS gravitates around the Guarantee Fund for Depositors and Investors (hereinafter 'DGS') that provides financial coverage to depositors and investors of all Danish banks, MCIs, and investment companies. The legal framework governing the DGS comprises the Guarantee Fund for Depositors and Investors Act (DGS Act), as lastly amended in June, 2013 and Executive Order no. 679 of November 13, 2013, implementing the EU DGS Directives.<sup>51</sup> The DGS is mandated to cover losses to depositors and investors in case of financial reconstruction or bankruptcy, and participates in the winding-up of failing banks under the Financial Stability Act. The role of the DGS in bank resolution matters (Figure 5) is discussed in more detail in Box 6.

<sup>51</sup> Directives 94/19/EC and 2009/14/EC. In April 2014, the European Parliament adopted the recast DGS Directive (2014/49/EU) that, amongst others, seeks to reduce repayment deadlines, harmonize financing arrangements and improve depositor information.

### Box 6. Guarantee Fund for Depositors and Investors's Involvement in Resolution Matters

Current legislation provides for three distinct roles for the GF in resolution matters.

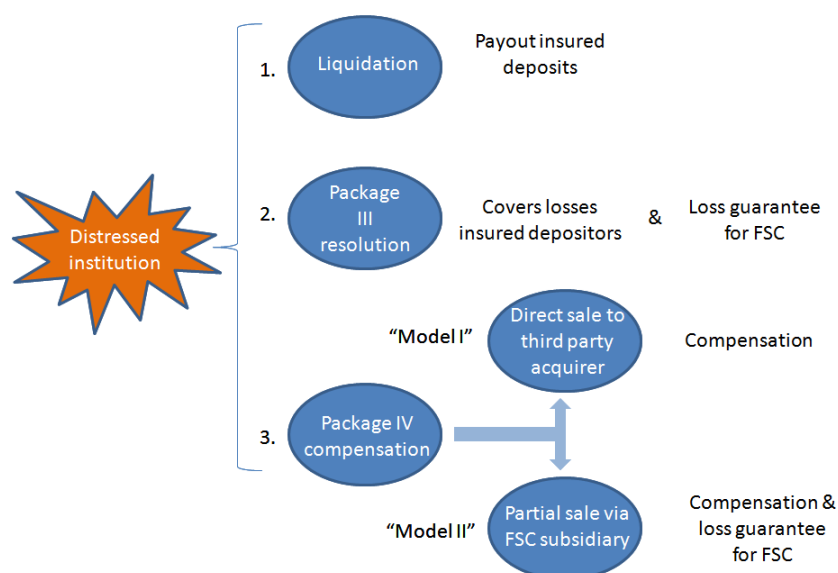
In a liquidation scenario, eligible deposits receive coverage from the DGS Banking Department up to the insured amount of €100,000, with claims being calculated after deduction of obligations to the relevant institution. A limited number of 'special' deposits (e.g., personal pension accounts, educational savings, and children's savings accounts) are covered in full.

Under a Bank Package III resolution, a proportionate share of insured deposits, equal to the proportion of other nonsubordinated liabilities that were transferred, is transferred to the FSC subsidiary. The FSC subsidiary supplements the accounts of insured depositors up to the insurance cap, with the subsidiary being subrogated to the depositor's claims against the GF.

In parallel, the Winding-up and Restructuring Department of the DGS, funded via undrawn commitments provided by the Danish banks, is mandated to participate in the winding up of distressed banks by providing loss guarantees to the FSC, covering any losses that may arise from the resolution. To date, the Winding-up and Restructuring Department has issued loss guarantees in connection with the winding up of Amagerbanken (2011), Fjordbank Mors (2011), Max Bank (2011), and Sparebank Østjylland (2012).

In June 2011, it became possible for the Banking Department of the DGS to provide financial support to a third-party acquirer of a distressed bank. This compensation scheme was refined under Bank Package IV, providing for direct sales to third parties, or partial sales via an FSC subsidiary. The decision to provide support rests with the DGS's Board of Directors, with such support being granted if this would result in smaller outlays for the DGS than a 'traditional' resolution under Bank Package III, and if the acquisition would be deemed commercially viable. To date, compensation has been provided in connection with the sale of (part of) the assets and liabilities of Max Bank (2011), Sparebank Østjylland (2012; both Bank Package IV), and Spar Salling Sparrekasse (2012; Bank Package III).

Figure 5. DGS involvement in bank resolution



## A. Scope and Coverage

**52. Membership of the DGS is compulsory for all banks and MCIs operating in Denmark.** At end-2013, the DGS comprised 150 institutions, including 99 banks and seven MCIs. In line with the EU DGS Directives, deposits held at Danish branches of banks headquartered in other member states are covered by the DGS of the home state, while DGS protection extends to deposits held at branches of banks from third countries.

**53. In line with the EU DGS Directives, coverage is provided up to €100,000 (approximately DKK 745,000), albeit with certain exceptions.** Certain deposits—including deposits belonging to directors of the respective institution, subordinated debt and deposits originating from transactions that are subject to a judgment concerning money laundering—are excluded from coverage, while others are covered in full, without application of the aforementioned cap or deduction of any loans or other liabilities. Such fully covered deposits include savings schemes established by law—such as lump-sum—and installment pension accounts, children’s savings accounts, home savings contracts, and educational savings accounts, as well as (temporary) deposits that relate to the purchase of noncommercial real estate for a period up to nine months from the deposit. At end-September 2013, net covered deposits amounted to about DKK 845 billion, approximately 43 percent of total deposits.

**54. The practice of offsetting depositor claims against financial obligations to the failed firm should be limited.** Under the DGS Act, depositors’ claims for coverage are calculated after deduction of any obligations to the relevant institution. To avoid hardship on depositors whose loans are in good standing and allow for more efficient reimbursements, the mission recommends limiting the offsetting of insured deposits, at maximum with loans that are past due.<sup>52</sup> Moreover, limiting offsetting (as per the recast DGS Directive) will help increase the base for calculating industry contributions and thus allow for a stronger funding base of the DGS.

## B. Governance

**55. The current governance structure of the DGS could jeopardize its institutional independence.** The DGS is managed by a Board of Directors whose members are appointed by the MoBG for a period of 3 years. Four out of the eight Board members of the DGS, including the chairman and deputy chairman, are independent, while the four remaining Board members are industry representatives—with two members thereof representing the banks, one member representing MCIs, and one member representing investment firms. While current governance arrangements provide certain safeguards against potential conflicts of interest—notably, by

<sup>52</sup> An important consideration against setting off depositor claims against outstanding loans and liabilities is that such requirements can pose a significant challenge to timely reimbursements. In fact, a survey from the International Association of Deposit Insurers (IADI), conducted among 27 deposit insurers, highlighted that setting off depositor claims is seen as the fourth most challenging impediment to effective reimbursements. See [http://www.iadi.org/docs/IADI\\_Guidance\\_paper-Developing\\_Effective\\_Reimbursement\\_Systems\\_and\\_Processes-Final\\_201210\\_\(2012-12\\_to\\_IADI\).pdf](http://www.iadi.org/docs/IADI_Guidance_paper-Developing_Effective_Reimbursement_Systems_and_Processes-Final_201210_(2012-12_to_IADI).pdf).

precluding Board members from participating in Board meetings if the relevant members, or their spouses and other relatives, have a personal or economic interest in the outcome of the case—the inclusion of industry representatives may nonetheless limit opportunities for early engagement between the DGS and other public stakeholders in case of mounting distress in individual institutions.

**56. Further improvements of DGS’s governance should be considered, with the aim to insulate the DGS from undue political and industry influence.** To strengthen the DGS’s institutional and operational independence and foster early information sharing between, notably, the DFSA and the DGS, the authorities should consider the removal of industry representatives from the DGS’s Board, while simultaneously strengthening ex post accountability and industry representation via the introduction of an oversight body. Moreover,

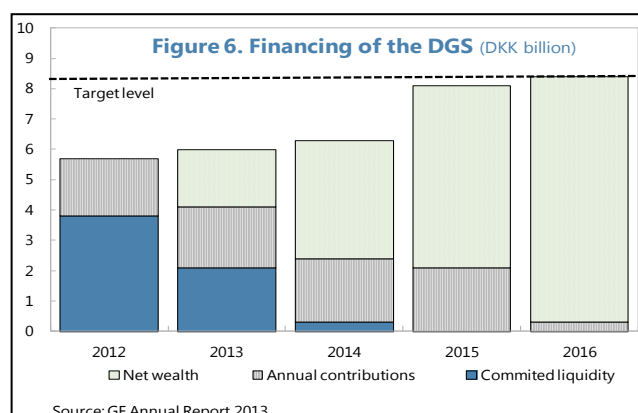
- Fit-and-proper criteria should be introduced for all Board members;
- Reasons for early removal from office of Board members should be explicitly stated in legislation, with mandatory disclosure of such reasons in individual cases; and
- Legal protection should be introduced—covering the DGS, its Board members, and its staff—for decisions and actions taken in good faith while discharging their duties.

### C. Funding

**57. In general, sole reliance on ex post contributions from the industry can undermine the credibility of DGS.** Up to March 2012, financing of the DGS was organized on the basis of ex post loss sharing, with member banks contributing to the outlays of the DGS based on each bank’s share of total covered net deposits. While ex post funding arrangements may, arguably, enforce market discipline as banks have a stronger incentive to monitor each other’s activities, they can also foster moral hazard and tend to be procyclical, with potentially large costs being imposed on the banking system at times when bank resilience may already have been eroded—possibly contributing to further financial fragility.

**58. Thus, the Danish authorities amended the funding arrangements of the DGS’s Banking Department through Bank**

**Package IV.** Acknowledging the drawbacks of an ex post funded system, the authorities decided to move toward an ex ante financed system, opting for a target fund of 1 percent of covered net deposits (amounting to, approximately, DKK 8 billion) with an annual contribution of 0.25 percent of net covered deposits. DGS’s Board has the right to increase contributions as an extraordinary measure



if the financial situation so requires, whereas the DFSA can (after consultation with the DN) mandate such an increase. To ensure that the liquidity of DGS's Banking Department remains adequate, the Board of Directors is required to maintain liquid assets (to be deposited in an account at the DN) and loan commitments up to, at least, 0.75 percent of covered net deposits. While the introduction of a prefunded DGS is a welcome initiative, efforts to build up its resources remain important, also in light of the recommended limitation of current offsetting practices (which points to a higher funding target for the DGS).

**59. The introduction of ex ante industry contributions does not diminish the need for a credible backstop arrangement.** Current legislation envisages two alternative funding sources (in addition to a potential increase of banks' annual contributions) that the DGS's Banking Department could immediately draw on. First, departments are allowed to borrow an amount up to 50 percent of the required amount of cash resources of the other departments, subject to a maximum of DKK 100 million per department in a single financial year. Moreover, the DGS may raise loans in the market against a guarantee provided by the Danish state (subject to the approval of the state's Finance Committee). While these arrangements provide additional safeguards, they may prove insufficient at times of severe stress and may have adverse signaling effects. Thus, as an alternative to market-based borrowing, the Danish authorities should consider providing the DGS with an unsecured credit line from the MoF (with funds to be made available by the DN)<sup>53</sup> that could be drawn down immediately.

## D. Reimbursements

**60. The mission recommends a shortening of the maximum reimbursement period.** At present, the DGS Act prescribes a maximum reimbursement period of 20 business days after commencement of financial restructuring or bankruptcy proceedings, with the possibility to extend this period with another 10 business days. While this period is in line with current EU DGS Directives, a reimbursement period of 20 (30) days may give rise to financial difficulties for depositors who, in case of a payout, could temporarily lose access to their funds. A shorter maximum payout period (which is also mandated by the recast DGS Directive that was adopted by the EU parliament in April 2014) should be considered. Past experiences with resolving distressed institutions over the course of one weekend suggest that banks are already able to deliver the necessary information for prompt payouts within a very short timeframe.<sup>54</sup>

**61. Advance preparation is critical for prompt reimbursements.** Reimbursing depositors can be a complex undertaking that requires a robust infrastructure that provides DGS with clear legal authority to direct banks to submit accurate depositor records, strategies, and approaches

<sup>53</sup> Reflecting that while the Minister of Finance is authorized by law to raise government loans, the actual management of the central government debt is carried out by the DN on behalf of the Ministry of Finance.

<sup>54</sup> It is noted that the Danish practice of resolving distressed banks via a transfer of assets and (part of) the liabilities ensures that insured depositors retain continuous access to their funds, thus rendering 'traditional' payouts redundant. Notwithstanding, timely payout capabilities should be maintained as a credible alternative to asset and liability transfers, if only to further reinforce depositor confidence.



for handling depositor records; coordination protocols with other safety net players and service suppliers, as well as policies; as well as controls and authorities within the governance structure of the deposit insurer that will guide the management of the reimbursement process.<sup>55</sup> In addition, certain preparatory activities can help to improve operational readiness of the DGS, typically allowing for quicker reimbursements.

## LEGAL PROTECTION

### **62. Danish supervisory and resolution authorities and their staff should have legal protection against liability in the context of the performance of their duties in good faith.**

The latter should be able to take actions while discharging their duties without the threat of lawsuits that could affect their judgment and possibly lead to leniency on their behalf vis-à-vis the institutions. Liabilities might occur when, inter alia, the authority failed to take any action notwithstanding the knowledge of serious problems in the bank; when measures were inadequate in response to the problems; or when a shareholder or a creditor of a bank challenges a resolution measure. Given that such actions taken by competent authorities (including official administrators and staff) can have far-reaching consequences and, as such, are intensively scrutinized, consideration should be given to the introduction of legal amendments that limit liability in the event of gross negligence or willful misconduct on the part of authorities. In the same vein, if employees of the said authorities are subject to personal lawsuits, they should have a statutory right to be indemnified for the costs and expenses incurred in defending themselves.

**63. Similarly, administrators, liquidation trustees, and the DGS should enjoy legal protection.** The law grants the administrators and trustees broad powers to restructure, or unwind (as the case may be) financial institutions. Thus, they should also benefit from legal protection for actions taken to discharge their duties in good faith. Finally, and as highlighted above, the DGS, its Board, and staff also warrant a similar degree of legal protection, acknowledging their involvement in resolution actions.

**64. Directors of institutions under resolution should be protected for actions taken when complying with decisions of the resolution authority.** The management of a bank that has been placed in resolution could be subject to lawsuits by the bank's shareholders and creditors as a result of complying with the decisions and instructions taken by the resolution authority and its staff. The authorities are encouraged to grant the firm's management statutory protection against possible liability, to the extent that such protection is limited to implementing the measures decided by the resolution authority. Naturally, such protection should not discharge management for actions (or non-actions) taken prior to the initiation of resolution proceedings; in particular, where this may have contributed to the build-up of distress to ultimately prompt the resolution action.

<sup>55</sup> See Executive Order No. 1135 dated September 29, 2010.

## Annex I. Banks Taken Over by the Financial Stability Company

Since 2008, 12 Danish banks have been taken over by the FSC under one of the Bank Packages.<sup>56</sup>

### Bank Package I

- EBH Bank November 21, 2008
- Løkken Sparekasse March 2, 2009
- Gudme Raaschou Bank April 16, 2009
- Fionia Bank May 28, 2009
- Capinordic Bank February 11, 2010
- Eik Banki September 30, 2010
- Eik Bank Danmark September 30, 2010

### Bank Package III

- Amagerbanken February 6, 2011
- Fjordbank Mors June 24, 2011

### Bank Package IV

- Max Bank October 8, 2011
- Sparekassen Østjylland April 21, 2012

### Other

- On March 2, 2012, the FSC concluded an agreement on the takeover of property exposures and related financial contracts from FIH.

At end-December 2013, residual exposures of the FSC for windingup FSC amounted to approximately DKK 16.5 billion, largely consisting of customer deposits (DKK 12.8 billion).

DDK Billion	Taken over since 2008	Wound up until end-December 2013
No. of individual customers	459,000	456,000
Net loans and guarantees	99	86
Deposits	65	64
Number of employees	Approx. 2,600	Approx. 2,500

<sup>56</sup> Roskilde Bank (resolved prior to the implementation of the Bank Packages) was transferred to FSC in August 2009. FSC is in the process of winding-up Roskilde's residual activities.

## Annex II. Danish Bank Packages

During the financial crisis, and in the aftermath thereof, the Danish authorities implemented various measures (also known as Bank Packages) to safeguard financial stability.

**Bank Package I** (October 2008): established a general state guarantee (terminated in September 2010) for all claims of depositors and other unsecured creditors, with the financial sector covering losses up to DKK 35 billion (2 percent of GDP). The package also created the FSC with mandate to wind-up distressed firms.

**Bank Package II** (January 2009): established facilities for the provision of state-guaranteed senior funding and solvency support (through hybrid Tier 1 capital instruments). When the scheme expired in December 2010, banks had drawn DKK 46 billion (around 3 percent of GDP) in solvency support and DKK 193 billion (12.5 percent of GDP) in state-guaranteed debt instruments. At the time of the mission, almost all government guaranteed bonds issued in 2009–10 had been redeemed.

**Bank Package III** (October 2010): introduced a new scheme for the orderly resolution of (non-systemic) distressed firms. The scheme provides for the transfer of the distressed firms' assets to the FSC, with all unsecured (and uninsured) creditors being subjected to a haircut (including depositors above DKK 750,000 (EUR 100,000)).

**Bank Package IV** (September 2011): introduced a compensation scheme for viable institutions that acquire the assets of distressed firms, either directly or via the FSC. Moreover, the Package strengthened the funding structure of the Danish Guarantee Fund for Depositors and Investors via the introduction of annual fixed payments.

**Bank Package V** (March 2012): ensured that Danish businesses have access to financing, inter alia via the allocation of additional resources for growth and export financing. In addition, the scheme governed the sale of real estate loans from FIH Erhvervsbank to the FSC, backed by an unlimited loss guarantee provided by the bank's parent company.

**Bank Package VI** (October 2013): introduced more stringent solvency and liquidity requirements for systemically important banks and mortgage credit institutions.