Introduction and summary

Background

On 12 January 2012 the Danish Minister for Business and Growth set up the Committee on Systemically Important Financial Institutions in Denmark. The Committee was established on the basis of a political agreement reached on 25 August 2011 between the former government (Denmark's Liberal Party and the Danish Conservative People's Party), the Danish Social Democrats, the Danish Social-Liberal Party, the Socialist People's Party, the Danish People's Party and Liberal Alliance, encompassing a number of consolidation initiatives (Bank Package 4).

The Committee was commissioned to consider criteria by which banks and credit institutions should be identified as being systemically important financial institution (SIFI) in Denmark, requirements that these Danish SIFIs should meet, and how Danish SIFIs in distress should be handled. The terms of reference of the Committee are enclosed as Annex 1.

The Committee held 16 meetings during 2012 and 2013, and relevant experts have been interviewed by the Committee.

In accordance with its terms of reference, the Committee has exclusively considered credit institutions, which comprise banks and mortgage-credit institutions in Denmark. The Committee has not considered whether financial institutions other than credit institutions – e.g. insurance companies or pension funds – could be SIFIs in Denmark.

Against this background, the Committee has prepared this report for the Minister for Business and Growth. The report includes a number of recommendations on identifying Danish SIFIs, requirements for Danish SIFIs, as well as crisis management of Danish SIFIs. A key message of the report is that tighter requirements for Danish SIFIs are vital in order to underpin financial stability, and to reduce the risk of the state bearing costs in connection with crisis management of Danish SIFIs. Strong protective measures, notably in the form of capital and liquidity requirements, combined with intensified supervision and an effective recovery plan are to minimise the probability of SIFIs encountering problems so serious that crisis management is required.

International developments

The Committee’s recommendations should be seen in the context of the current work at the international level on the regulation of credit institutions. At EU level, the key directives and regulations addressing the regulation of credit institutions, including national SIFIs, have not yet been finalised. In particular, negotiations on the revision of the Capital Requirements Directive (CRD4)[1], where a political agreement has been reached in the beginning of March but where a technical finalisation of the directive is awaiting, and the Directive on the recovery and resolution of credit institutions have not yet been concluded.[2] Adoption of a full set of rules at EU level is not expected until the second half of 2013 at the earliest, and implementation of the rules in national legislation is not expected until 2014-15. Accordingly, it remains unclear to which exact extent there will be flexibility at the national level to establish specific rules for identification of SIFIs, requirements for SIFIs and crisis management of SIFIs. The Committee has therefore taken as its starting point the proposals for future EU rules and possible political agreements, or, when appropriate, the latest compromise proposals, and on this basis it has made its assessment of the most appropriate solutions and recommendations in a Danish context.

A framework for common EU supervision of credit institutions under the auspices of the European Central Bank is currently being negotiated.[3] Moreover, it is expected that discussions on a common crisis management regime at EU level will begin in the course of 2013. These proposals – possibly together with a proposal on a common deposit guarantee scheme – comprise the so-called “Banking Union”. It has not yet been decided whether Denmark should participate in a Banking Union. If Denmark decides to participate, this may have significant consequences for the regulation of SIFIs in Denmark, including whether it will be possible or necessary to implement the Committee’s recommendations.

In this light, it may be relevant to implement the Committee’s recommendations in stages. The Committee’s recommendations on identification of and requirements for SIFIs, which are primarily linked to CRD4, could thus be implemented by 2014. In contrast, because negotiations on the crisis management of financial institutions at EU level are less advanced, a balance has to be struck between implementing a crisis management regime for Danish SIFIs as soon as possible, and awaiting adoption of EU rules in order to ensure compatibility with international rules.

Furthermore, requirements for the internal organisation of credit institutions, and notably, the separation of retail activities and investment activities, are currently being debated internationally. Specifically, such requirements have been proposed in the UK, France and Germany, and the so-called Liikanen group has proposed similar requirements at EU level.[4] The Committee finds it appropriate to await possible future EU rules before deciding whether such requirements may be relevant for Danish SIFIs.

[1] European Commission, ”Proposal for a directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (COM 2011/453)” and “Proposal for a regulation of the European Parliament and the Council on prudential requirements for credit institutions and investment firms (COM 2011/454)”.

[2] European Commission, “Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (COM 2012/280)”.

[3] European Commission, “Proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (COM 2012/511)”.

[4] High-Level Expert Group on reforming the structure of the EU banking sector, “Final Report (Liikanen Report)”, 2. October 2012.

The terms of reference state that, as far as possible, the Committee should strive to ensure equal terms of competition between SIFIs and other credit institutions in Denmark, as well as between Danish SIFIs and SIFIs in other countries. With regard to competition between SIFIs in Denmark and SIFIs in other countries, the challenge is that EU rules in this area have not yet been finally determined and only few European countries have implemented actual regulation of their national SIFIs. The Committee has therefore based its assessment on the view that Danish regulation of SIFIs should as far as possible take into account Danish societal interests, even if this means that equal competitive terms cannot be fully secured.

Considerations concerning the regulation of SIFIs

A well-functioning financial sector is an important prerequisite for a modern economy as it ensures financing of activity in society by distributing money from those who have excess liquidity and savings to those in the business community that require funds to finance their activities, and for households that want to finance housing purchases and other investments.

However, risks can build-up in the financial system which may influence the economy as a whole. Such risks can be due to SIFIs. In the view of the Committee, it is essential to limit the probability of a SIFI encountering difficulties, by setting a number of additional requirements for Danish SIFIs. These additional requirements aim to minimise the probability of SIFIs encountering problems, and to limit the costs to society and the state, if this should happen anyway. Thus, additional requirements aim at underpinning financial stability by making the institutions more resilient, even under severe stress.

To a certain extent, additional requirements for SIFIs may increase their costs, as additional capital will need to be raised. Increased costs could influence the possibility for the relevant institutions to provide lending, particularly in the period where the institution is adapting to the additional requirements. This may have a negative effect on the entire economy.

It is, however, the view of the Committee that the total effect on the economy of the proposed additional requirements will be positive. A stable financial sector is a basic prerequisite for long-term growth and employment. Furthermore, possible negative effects have been sought remedied through phasing-in periods and non-simultaneous implementation of the Committee's recommendations, whereby the requirements will not all have to be implemented at the same time. Furthermore, most Danish SIFIs have already carried out part of the adjustment which will be necessary following the Committee's recommendations. This is because credit institutions are already expecting additional future regulation, and are seeking to meet the financial markets' higher expectations for how much capital financial institutions should hold. This reduces the immediate negative effects on the sector. Furthermore, the total costs of additional capital requirements are not necessarily large, as better capitalised institutions will usually be met with a lower expected return from creditors and shareholders and thus lower funding costs.[5]

The Financial Stability Board (FSB)[6] and the Basel Committee on Banking Supervision (BCBS)[7] have estimated that the total effect on the economy of the international capital requirements, including the special requirements for global systemically important banks, will be positive. The full requirements are estimated to have a negative impact on global GDP of 0.3 per cent during the phasing-in period, while the long-run permanent positive effects of a reduced likelihood of a future systemic banking crisis will result in a higher global GDP of 2.5 per cent.[8] Similarly, the European Commission estimates that the positive effects of the CRD4 proposal will result in a higher EU GDP of around 2 per cent in the long run.[9]

The Committee's recommendations should be viewed in light of the Danish Bank Package 3, which has put Denmark ahead in Europe in creating a specific winding-up model for banks where creditors and the banking sector can help bear losses incurred in the winding-up process. Contrary to the consequences of a traditional bankruptcy, this model ensures proper winding-up of a bank in distress. The European Commission's proposal for a directive on the recovery and resolution of credit institutions is based on much the same principles as Bank Package 3. However, agreement has not yet been reached on the EU rules, and the provisions of the proposed write-down of creditors will most likely not enter into force until 2018 at the earliest. It is unclear how other EU countries will manage credit institutions in distress until the EU rules enter into force.

However, it is the view of the Committee that Bank Package 3 and the existing winding-up scheme for mortgage-credit institutions will generally not suffice for managing distressed SIFIs. To protect the economy, it will be necessary to allow systemic functions of a SIFI in distress to keep operating, rather than winding up the entire institution. In addition, even with compensation from the Guarantee Fund for Depositors and Investors, it is very uncertain whether a buyer for a SIFI in distress can be found, even if foreign buyers are a possibility. Thus, the current assumption must be that the government could be compelled to intervene if, in a specific situation, it is perceived that the derived effects of a winding-up will be more harmful for the economy, including the government's finances, than if the government takes on a risk in relation to crisis management. The stronger the expectation among market participants that a SIFI will receive public support if it is in distress, the cheaper the institution will be able to fund itself.

[5] See e.g. Admati, A., DeMarzo, P., Hellwig, M. og Pfeiderer, P., "Fallacies, Irrelevant Facts, and Myths in Capital Regulation: Why Bank Equity is not Expensive", Stanford University Working Paper No. 86, 2010.
[6] The Financial Stability Board is an international committee at the Bank for International Settlements which works to ensure implementation of effective regulation and supervision of the financial sector.
[7] The Basel Committee on Banking Supervision (BCBS) is a committee at the Bank for International Settlements which works to develop international regulation of the banking sector. The BCBS has 28 members from countries with the largest financial sectors.
[8] BCBS and FSB, "Assessment of the macroeconomic impact of higher loss absorbency for global systemically important banks", 10. October 2011.
[9] See note 1.

The Committee therefore recommends creating appropriate protective measures for SIFIs in order to prevent SIFIs becoming distressed. Since the risk of a SIFI becoming distressed cannot be entirely eliminated in a market economy, it is further recommended that additional crisis management tools[10] are provided for the authorities than what is included in Bank Package 3 and the existing winding-up scheme for mortgage-credit institutions. Such tools aim to provide the best possible basis for carrying out crisis management, if this should nevertheless become necessary, with as few harmful effects on the economy as possible and without costs for the state.

Criteria for identifying SIFIs

Until now, only few countries have formally identified their national SIFIs. The Committee has taken note of the very different criteria and limits that have been proposed or implemented in Sweden, the United Kingdom and Switzerland, which also have addressed the issue of identifying national SIFIs. The Committee recommends identifying Danish SIFIs on the basis of size and substitutability. The latter refers to the fact that certain functions, particularly credit institution's lending, cannot easily be taken over (substituted) by other institutions within a short time horizon.

Specifically, it is proposed that Danish SIFIs be identified at a consolidated level on the basis of the total assets of the institutions in relation to GDP, the institutions' deposits in Denmark as a percentage of the total deposits of the credit institution sector in Denmark and the institutions' loans in Denmark as a percentage of the total loans of the credit institution sector in Denmark. An institution should be identified as a SIFI based on just one of the three indicators in order to be identified as SIFI in Denmark. The limit for identification is set at 10 per cent for the total asset indicator and 5 per cent for the indicators for loans and deposits. It is recommended that the Danish FSA which – due to its supervision of the sector – is the natural authority in the area designates Danish SIFIs based on a recommendation from the Systemic Risk Council. Designation should be re-evaluated each year. A general gradual phasing-in of requirements for newly designated SIFIs over for example two years is considered to be appropriate.

If the recommended quantitative approach is applied, six credit institutions will be identified as SIFIs in Denmark, cf. Table 1. The bold font indicates the threshold values exceeded by these institutions.

[10] In the report the term "crisis management" is consistently used in relation to the handling of distressed SIFIs instead of the term "resolution" which is used in relation to the handling of other credit institutions. Similarly the terms "crisis management plans" and "crisis management authority" is used instead of the terms "resolution plans" and "resolution authority". When describing the proposal for an EU-directive on recovery and resolution of credit institutions the term "resolution" is used even if the proposal also covers SIFIs since this term is used in the proposed directive.

Table 1: Danish banks and mortgage-credit institutions which fulfil the quantitative criteria for identification as SIFI, consolidated level, June 2012

	Total assets in per cent of GDP	Loans in per cent of the total loans of the sector	Deposits in per cent of the total deposits of the sector
Danske Bank	**182.6**	**30.6**	**32.6**
Nykredit	**80.4**	**30.8**	4.0
Nordea Bank Danmark	**48.9**	**15.9**	**22.2**
Jyske Bank	**14.4**	3.2	**8.9**
BRFkredit	**12.6**	**5.2**	0.4
Sydbank	8.9	1.9	**5.4**

As the quantitative indicators are simple and general, and thus do not necessarily capture all the elements that may make a credit institution systemic, it should be possible to include a qualitative element in the identification, under careful consideration. The qualitative element should allow for identifying more institutions as SIFIs than the institutions identified using a quantitative approach, or for identifying less institutions as SIFIs than those identified using a quantitative approach. In this regard, the Committee finds it particularly relevant for the Systemic Risk Council to consider recommending identifying DLR Kredit as a SIFI based on the institution’s large market share of lending to the agricultural sector which is difficult for other institutions to substitute in light of the current state of the sector.

Furthermore, it is recommended that credit institutions in the Faeroe Islands and in Greenland are identified as SIFIs on the basis of the same criteria and indicators as credit institutions in Denmark, but based on the size of the local sector and the local GDP, and possibly with other threshold values. In the view of the Committee, the question of who should identify SIFIs in the Faeroe Islands and in Greenland is a political one, and is related to the question of how to finance crisis management of SIFIs in the Faeroe Islands and in Greenland.

The Committee has not considered branches of foreign credit institutions in the identification of SIFIs in Denmark. Generally, the home country of the institution will set requirements and supervise branches abroad. The Danish FSA participates in supervisory colleges for the relevant institutions. This issue would have to be addressed if branches of foreign credit institutions became systemic in Denmark.

Requirements for SIFIs

The Committee recommends that Danish SIFIs become subject to an additional capital requirement of Common Equity Tier 1 capital.[11] The requirement is set on the basis of a quantitative measure of how systemic a SIFI is. A differentiated capital requirement of currently 1-3.5 per cent of the risk-weighted assets is recommended. It is furthermore

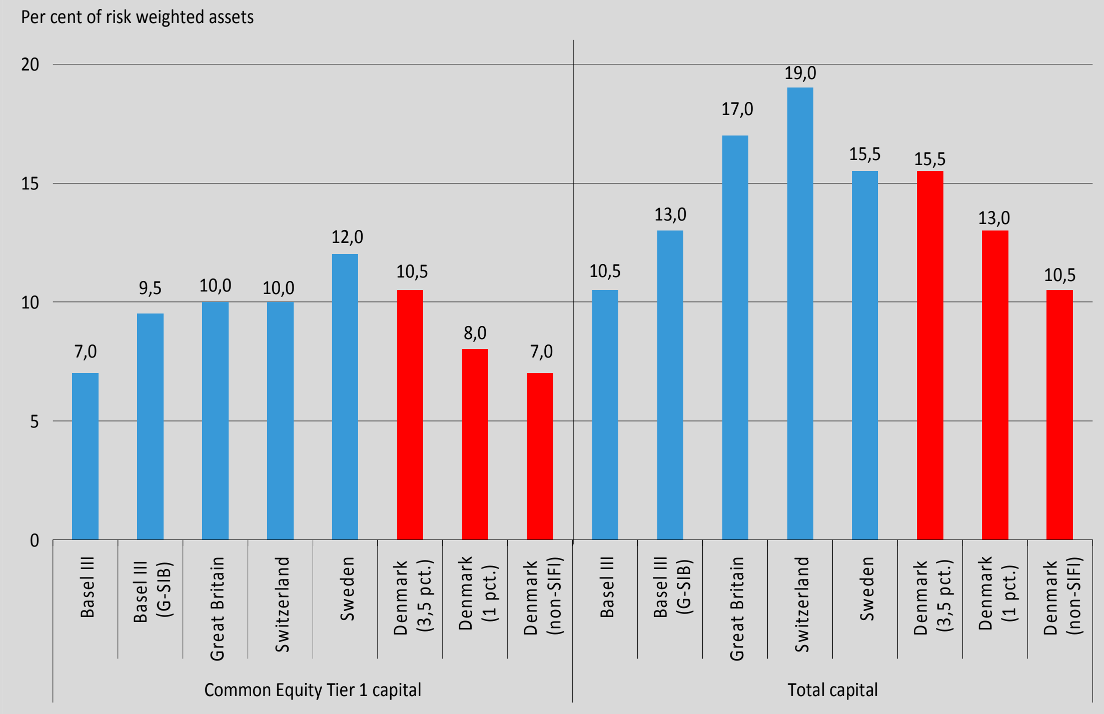
[11] Common Equity Tier 1 capital is the most loss-absorbing type of capital and is therefore seen as capital of the highest quality. Common Equity Tier 1 capital comprises e.g. shares, retained earnings etc.

recommended that the requirement may increase to 4 per cent or higher, if the SIFI becomes more systemic. The most systemic institutions will therefore become subject to the highest requirements, as it is the view of the Committee that risks increase more than proportionally when institutions become more systemic. The capital requirement may be adjusted by half a percentage point upwards or downwards on the basis of a qualitative assessment. However, the capital requirement may never be less than 1 per cent of the risk weighted assets. The capital requirement is to be phased-in over a number of years until 2019.

Moreover, the Committee recommends that all SIFIs, irrespective of how systemic they are, establish a “crisis management buffer” of 5 per cent of the risk weighted assets. The buffer may consist of debt instruments which can be converted into Common Equity Tier 1 capital or written down if the institution becomes subject to crisis management. Additional Tier 1 capital (“Hybrid capital”) and Tier 2 capital (“Subordinated capital”), used by the institution to fulfil the minimum capital requirement, may also be used to fulfil part of the crisis management buffer if the set requirements for the crisis management buffer are met. Following CRD4, Additional Tier 1 capital and Tier 2 capital can comprise 3.5 per cent of risk weighted assets, whereby the crisis management buffer will only imply an additional requirement of 1.5 percentage points, if Additional Tier 1 and Tier 2 capital is used. The crisis management buffer may also be satisfied with Common Equity Tier 1 capital if this is preferred by the institution. It is recommended that the crisis management buffer is established over a three-year period starting in 2020, i.e. when the additional capital requirement for SIFIs has been fully phased-in.

Figure 1 shows the Common Equity Tier 1 capital requirement for Danish SIFIs and the overall capital requirement for Danish SIFIs (Common Equity Tier 1 capital plus the crisis management buffer). The figure compares the requirements for Danish SIFIs with international minimum requirements for all credit institutions of 7 per cent Common Equity Tier 1 capital and 10.5 per cent total capital – which will be the requirements for Danish non-SIFIs – and for global SIFIs of 9.5 per cent Common Equity Tier 1 capital and 13 per cent total capital. Furthermore, a comparison is made with the capital requirements for SIFIs in the few European countries which have introduced, or are in the process of introducing, SIFI regulation.

Figure 1: Capital requirements for Danish and foreign SIFIs and non-SIFIs (fully phased-in)



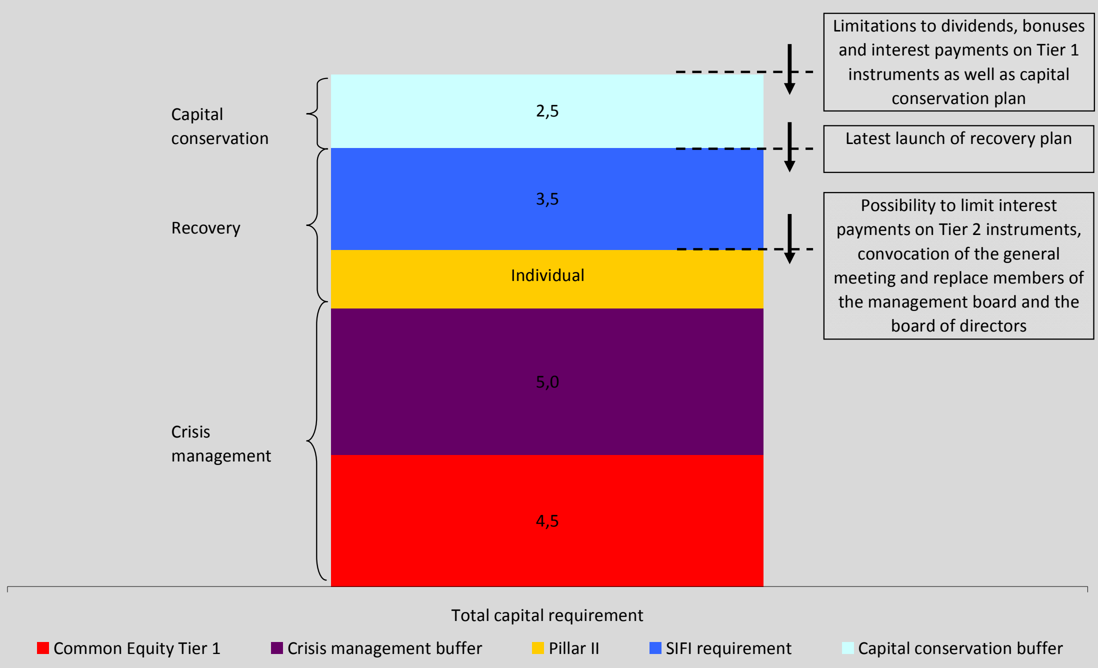
Note: The capital requirements for the most systemic SIFIs in different countries and internationally are stated as a percentage of risk weighted assets. For Denmark, this includes capital requirements for the most systemic and the least systemic SIFIs and for the other credit institutions, respectively.

As can be seen from Table 1, both the requirement for Common Equity Tier 1 capital as well as the total capital requirement for the most systemic Danish SIFI will be above the international minimum requirements for the most systemic global SIFIs. The total capital requirement for the most systemic Danish SIFI of 15.5 per cent will be at the same level as the requirements for SIFIs in Sweden, whereas the requirement for Common Equity Tier 1 capital of 10.5 per cent will be slightly lower than in Sweden. For the other Danish SIFIs, the requirements will be lower than in Sweden. A possible additional individual solvency requirement (pillar II requirement)[12] is not included in the figure since such requirement is not disclosed in other countries than Denmark.

[12] The individual solvency need is set by each institution in order to cover individual risks which are not covered within the minimum capital requirement. The Danish FSA can set a higher individual solvency requirement. In this report the term “pillar II requirement” is used in relation to the individual solvency need or an individual solvency requirement. Going forward the starting point will be that the pillar II requirement can only be fulfilled with Common Equity Tier 1 capital. The revision of the financial business act in December 2012 means that the Danish FSA can decide which type of capital the specific institution shall use to fulfil the pillar II requirement. It is stated in the comments to the law that the Danish FSA shall make an individual assessment of the circumstances of the specific institution but that the starting point will be that the Danish FSA will demand that the pillar II requirement is fulfilled by Common Equity Tier 1 capital. It is supplementary stated in the comments that Additional Tier 1 or Tier 2 capital which automatically converts to Common Equity Tier 1 capital or is written down if the solvency need or a relevant Common Equity Tier 1 trigger is breached can also be taken into consideration.

The Committee also recommends a strengthening of the powers of the Danish FSA to intervene before a SIFI has to undergo crisis management. Figure 2 illustrates the phases the institutions may go through and indicates which further tools should be made available for the Danish FSA in these different phases.

Figure 2: Tools for the Danish FSA in different phases



Note: The figure is based on the recommended capital requirement for the most systemic SIFI i.e. the SIFI-requirement is set at 3.5 per cent. A possibly pillar II requirement is not specified in the figure as this is set individually. The powers of intervention will be triggered at the stated level of total capital plus a pillar II requirement.

Failing to meet the capital conservation buffer will, pursuant to CRD4, lead to restrictions on the ability to make distributions to shareholders, pay variable remuneration to employees and make payments on Tier 1 instruments. Furthermore, pursuant to CRD4, institutions will be required to prepare and forward a capital conservation plan to the supervisory authority for approval. It is recommended that the capital conservation buffer is placed “at the top” in relation to the other capital requirements. Following the recommendations of the Committee, the most systemic institutions will enter this “capital conservation phase” at a level of total capital of 15.5 per cent plus the pillar II requirement and a level of Common Equity Tier 1 capital of 10.5 per cent plus the Common Equity Tier 1 capital which the institution uses to fulfil the pillar II requirement, cf. figure 2. The least systemic SIFIs will enter the capital conservation phase at a level of total capital of 13 pct. plus the pillar II requirement, and a level of Common Equity Tier 1 capital of 8 per cent plus the Common Equity Tier 1 capital which the institution uses to fulfil the pillar II requirement.

At the latest, the recovery phase will commence if the institution breaches the SIFI capital requirement. The Committee recommends that all SIFIs prepare individual recovery plans which at the latest are to be implemented if the institution breaches the

SIFI capital requirement. The recovery plans have to be approved by the Danish FSA. Following the recommendations of the Committee, the most systemic institutions will enter the recovery phase, and will at the latest have to implement the recovery plan, at a level of total capital of 13 per cent plus the pillar II requirement and a level of Common Equity Tier 1 capital of 8 per cent plus the Common Equity Tier 1 capital which the institution uses to fulfil the pillar II requirement. The least systemic SIFIs will enter the recovery phase at a level of total capital of 10.5 per cent plus the pillar II requirement and a level of Common Equity Tier 1 capital of 5.5 per cent plus the Common Equity Tier 1 capital which the institution uses to fulfil the pillar II requirement.

If the institution, in addition to the SIFI capital requirement, also breaches the pillar II requirement, the Danish FSA should be able to intervene more directly in order to ensure that further steps are being taken to recover the institution. The Danish FSA should have the authority to convene the general meeting of the institution, to replace members of the management board and board of directors, and to restrict payments on Tier 2 instruments. The Committee recommends that this phase of more direct intervention by the FSA commences at a level of total capital of 9.5 per cent plus the pillar II requirement and a level of Common Equity Tier 1 capital of 4.5 per cent plus the Common Equity Tier 1 capital which the institution uses to fulfil the pillar II requirement.

Further to the requirement for Danish SIFIs to develop recovery plans, the Committee also recommends that crisis management plans are developed for all SIFIs. Crisis management plans contribute to effective and appropriate crisis management of the institution in distress. Crisis management plans are to be developed by the crisis management authority in close cooperation with the Danish FSA and Danmarks Nationalbank (the central bank) and with the necessary involvement of the SIFI in question.

Apart from the additional capital requirements, the requirement to prepare recovery and crisis management plans and the strengthened early intervention powers to the Danish FSA, the Committee also recommends that Danish SIFIs become subject to additional liquidity and corporate governance requirements and finally that SIFIs become subject to intensified regular supervision.

The Committee recommends a faster full phasing-in of the short-term international liquidity requirement (LCR) for SIFIs than suggested in CRD4. This is considered relevant since the recent financial crisis showed that access to funding when the markets are under stress can be crucial for the ability of credit institutions to survive. Thus, it is recommended that the requirement is phased in fully by 2015, whereas CRD4 allows for a gradual phasing-in until 2018. More stable funding requirements are also recommended for SIFIs by 2014. Specifically, it is proposed to set requirements for the amount of the institutions' funding stemming from for example retail customers and market funding with a maturity of more than one year as a per cent of the total loans of the SIFI. When implementing this requirement, special consideration should be given to the mortgage credit activities of the SIFI.

In relation to corporate governance it is recommended that the requirements include fit and proper requirements for managerial staff, risk management functions and the IT area. Such requirements are to contribute to ensuring responsible and effective operation of the institutions.

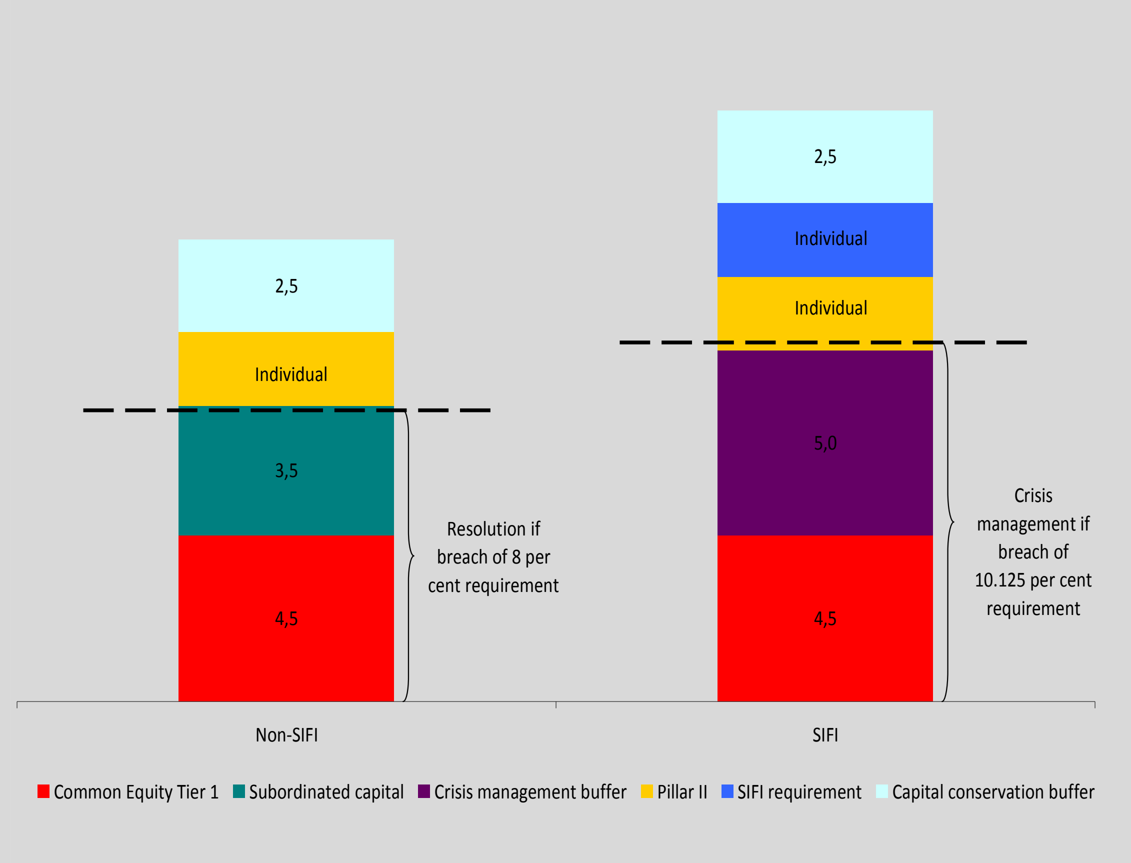
The strengthened regular supervision of Danish SIFIs should provide the authorities with a more solid basis for early intervention in relation to SIFIs if necessary. Strengthened supervision is recommended to include corporate governance, model risk, capital allocation, enhanced examination activities and intra-group exposures.

Crisis management of SIFIs

Based on the special challenges of managing distressed SIFIs, including the need to maintain the lending capacity to the economy, the Committee recommends introducing a special approach for the crisis management of SIFIs including alternative tools to Bank Package 3 and the existing winding-up scheme for mortgage-credit institutions.

Figure 3 shows the composition of the capital requirement for SIFIs and non-SIFIs and illustrates that different approaches are recommended for when SIFIs and non-SIFIs should be subject to crisis management or resolution.

Figure 3: Trigger for resolution or crisis management for Danish SIFIs and non-SIFIs



For non-SIFIs, resolution will commence if the institution breaches the 8 per cent minimum capital requirement, cf. figure 3. This is also the case today. For SIFIs, the 8 per cent minimum capital requirement will be less relevant. The Committee recommends crisis management to commence if a SIFI breaches a requirement of 10.125 per cent total capital, comprising the minimum requirement of Common Equity Tier 1 capital of 4.5 per cent, plus a small add-on of 0.6125 per cent following CRD4, and the crisis management buffer of 5 per cent. The crisis management buffer will be converted into Common Equity Tier 1 capital when crisis management commences. If the institution chooses to fulfil the crisis management buffer with Common Equity Tier 1 capital, the trigger for crisis management will be 10.125 per cent Common Equity Tier 1 capital. If the institution fulfils the crisis management buffer with convertible debt instruments and breaches a threshold of 5.125 per cent Common Equity Tier 1 capital this will also be a trigger of crisis management. Furthermore, the Danish FSA should have the power to decide that an institution has to undergo crisis management if the institution is not viable. The reason for initiating crisis management for SIFIs earlier than for other institutions is to ensure that sufficient capital is available in the SIFI – specifically around 10 per cent Common Equity Tier 1 capital – to continue the operation of the systemic activities of the institution and reduce further losses.

Less well-capitalised institutions might find it challenging to sell the necessary convertible debt instruments at a reasonable price and thus meet the requirement to maintain a crisis management buffer. In this case the requirement will in effect be an additional Common Equity Tier 1 capital requirement.

It is recommended that a crisis management authority is established, which should be given responsibility for crisis management of SIFIs, in addition to a range of legally established crisis management powers in relation to credit institutions. It should be considered how a crisis management authority can most appropriately be organised, including whether this role could be given to an existing institution e.g. the Financial Stability Company A/S. The crisis management authority should have a range of alternative tools available to conduct the crisis management of SIFIs.

The Committee recommends that the crisis management authority is given the possibility of mandatory use of the crisis management tools when managing distressed SIFIs. This is contrary to the tools of the previous bank packages, which all are voluntary. The need for a mandatory approach for SIFIs is based on the potential adverse effects on the economy if a SIFI decides to opt for bankruptcy instead of the proposed crisis management regime. A mandatory approach is also included in the proposal for a directive on the recovery and resolution of credit institutions. Mandatory crisis management tools can imply legal challenges, especially in relation to expropriation, which have to be addressed.

It should be noted that the recommended approach includes both a contractual possibility to write down or convert debt in relation to the crisis management buffer and statutory powers of write down or conversion of unsecured creditors. A contractual write down or conversion can not be expropriation.

The specific crisis management tools should include the power to transfer all or parts of an institution's assets, rights and liabilities to a bridge bank[13] which is wholly or partly owned by the state. The aim of a bridge bank is to ensure that all or parts of the functions of the institution are continued in a value-preserving manner. In particular, systemic functions should be carried on with the intention of later sale. The crisis management authority should be given the power to sell value-impaired assets to a publically owned company, with the intention to wind-up these assets. More generally, the crisis management authority should have the power to sell assets to a third party.

As a final measure, and after shareholders and subordinated capital have taken losses, it should be possible for the authorities to convert or write down unsecured creditors of the SIFI, in order to recapitalise or re-establish equilibrium in the balance sheet of institutions. A write down will reduce the liabilities of the institution, ensuring a balance between assets and liabilities. In practise, the tool should be used together with the bridge bank tool, and a recapitalisation will be necessary to make the institution viable going forward. Contrary to a write down in itself, a conversion of debt to equity will imply that by receiving shares in the institution, the creditors will be part of the future ownership of the institution. Thus, a recapitalisation of the institution is ensured through a conversion, and the institution can continue all or parts of the business with new ownership.

Finally, it will be relevant to set up a stability fund financed by Danish SIFIs and possibly SIFIs from Greenland and the Faroe Islands, to ensure a contribution from the financial sector to the costs of crisis management of SIFIs. A stability fund can be phased in from 2020, after full phasing-in of the additional capital requirement for SIFIs. When setting up the fund, it is recommended that international developments be taken into consideration, notably regarding the phasing-in of the fund, the fund's overall size and the possibilities for using the fund in practice.

One of the purposes of providing alternative crisis management tools is to provide the existing shareholders with a strong incentive to inject additional capital in the institution particularly in the recovery phase, with a view to avoiding significant dilution or write-downs of shareholder capital in a crisis management situation.

It should be clarified how the additional crisis management tools, and in particular the debt write down and debt conversion tools, can be implemented in a legally appropriate way in Denmark.

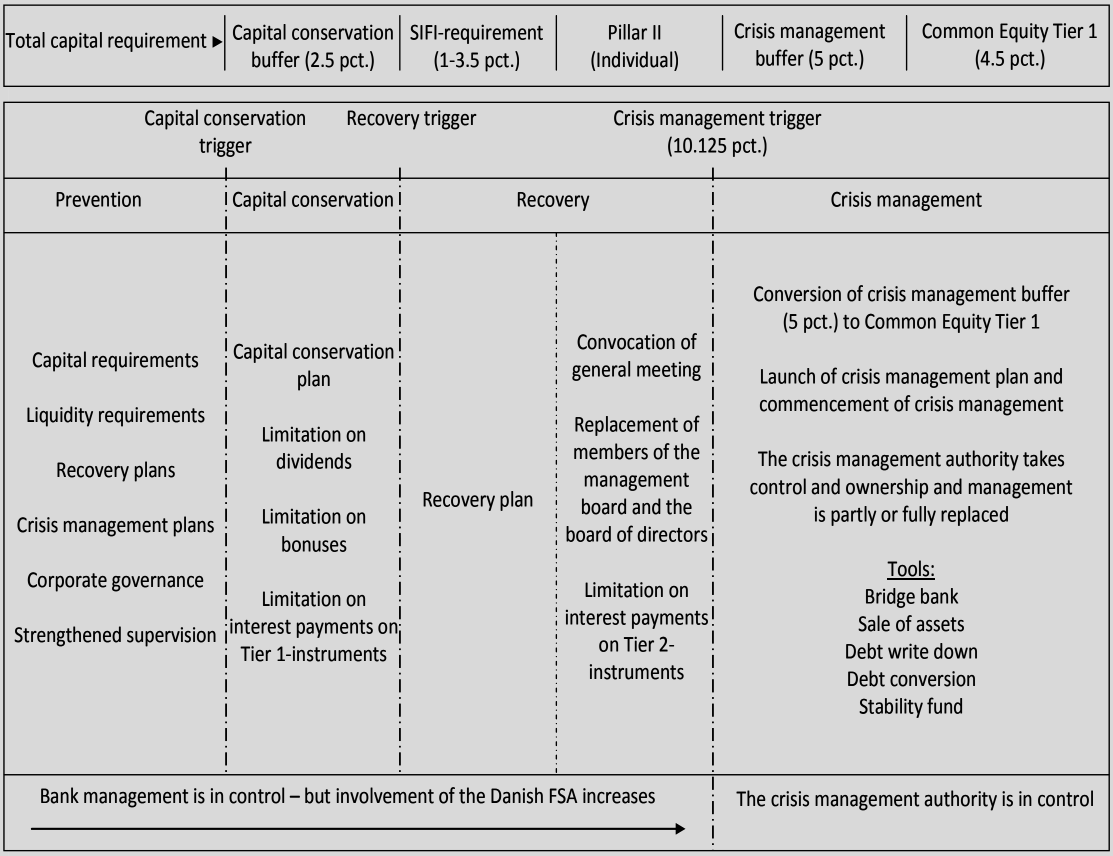
Summary

The Committee's recommendations regarding the requirements for and crisis management of SIFIs include a number of different elements which have been described above. Taken together, these elements constitute a system with the aim of preventing that SIFIs get distressed and for the crisis management of SIFIs if they nevertheless become distressed. Figure 4 gives an overview of this system for the

[13] A state owned temporary institution similar to the institutions set up by the Financial Stability Company A/S.

regulation of SIFIs. The complete recommendations of the Committee are listed in Box 1.

Figure 4: Overview of recommendations from the Committee in relation to requirements for and crisis management of SIFIs



Note: As a starting point the pillar II requirement shall be fulfilled with Common Equity Tier 1 capital, but may be fulfilled by subordinated capital which automatically converts if the institution breaches the solvency need.

Box 1: Complete recommendations of the Committee

It is recommended that:

Identification of SIFIs

- Danish SIFIs are identified at consolidated level on the basis of the size of the total assets relative to GDP, the size of loans relative to the total loans of the sector and the size of deposits relative to the total deposits of the sector. Identification as a SIFI will require that just one of the indicators has been met. In connection with identification, the possibility to include a qualitative element following careful consideration should be available.

- The threshold for identification is set at 10 per cent for the total asset indicator and 5 per cent for the indicators for loans and deposits.

- Designation is made by the Danish FSA based on a recommendation from the Systemic Risk Council. The designation is re-evaluated annually.

- Credit institutions in the Faeroe Islands and in Greenland are identified as SIFIs on the basis of the same criteria and indicators as credit institutions in Denmark, but based on the size of the local sector and the local GDP, as well as possibly other threshold values.

Requirements for SIFIs

Capital requirement

- A SIFI capital requirement is set which, with the recommended approach, is currently between 1 and 3.5 per cent of the risk-weighted assets, depending on the degree to which the institution is systemic. It is possible to set a higher requirement than 3.5 per cent if the institutions become more systemic.

- The SIFI capital requirement is met with Common Equity Tier 1 capital. The capital requirement is set at consolidated and individual level. The requirement is phased in until 2019.

- SIFIs are required to additionally hold a crisis management buffer consisting of debt which can be converted or written down. The buffer amounts to 5 per cent of the risk-weighted assets. Under certain conditions, this requirement can be met with existing hybrid capital and subordinated capital. The crisis management buffer is established over a three-year period starting in 2020.

Recovery and crisis management plans

- Recovery and crisis management plans for Danish SIFIs are prepared. Recovery plans are to be prepared by the institution itself and approved by the Danish FSA. Crisis management plans are to be prepared by the crisis management authority in close cooperation with the Danish FSA and Danmarks Nationalbank (the central bank) and with the involvement of the institutions deemed necessary. The plans are updated annually.

- The recovery plan is launched at the latest if the institution breaches the SIFI capital requirement. The Danish FSA should have further means of intervention if the institution breaches the Pillar II requirement. These include the authority to convene the general meeting of the institution and to replace members of the management and board of directors of the institution as well as to restrict payments on subordinated capital (Tier 2 instruments). The crisis management plan is launched if the institution is to undergo crisis management.

Liquidity requirements

- The short-term liquidity requirement (LCR) is phased in more quickly for SIFIs than what EU rules suggest. Concretely, SIFIs should fully meet the LCR requirement from 2015. Requirements are set for more stable funding for SIFIs from 2014, in order to ensure that the dependence of SIFIs on very short-term funding is reduced.

Corporate governance

- The existing fit and proper requirements are expanded to also apply to managerial staff of the SIFIs and not just to the board of directors and the management. Special requirements are set for the SIFIs' organisation and staffing of risk management functions as well as the IT systems.

Strengthened supervision

- SIFIs are subjected to strengthened supervision, which to a higher degree than today focuses on corporate governance, regular monitoring and dialogue, model risk and allocation of capital, increased inspection activity as well as intra-group exposures.

Crisis management of SIFIs

- The trigger point for beginning crisis management of a SIFI is set at 10,125 per cent total capital. This is in contrast to the trigger of 8 per cent for other credit institutions. Furthermore, the Danish FSA can decide to begin crisis management if the institution is no longer viable.

- A crisis management authority is established, and made responsible for crisis management of Danish SIFIs. It should be considered how a crisis management authority can most appropriately be organised, including whether this role could be given to an existing institution e.g. the Financial Stability Company A/S.

- It is made possible to make the use of the crisis management tools mandatory, contrary to the existing voluntary schemes.

- Alternative crisis management tools are introduced, providing the possibility of:
  - Establishing a bridge bank,
  - Selling assets,
  - Write-down of debt,
  - Debt conversion.

A stability fund financed by Danish SIFIs and possibly SIFIs from Greenland and the Faroe Islands is established, and phased in from 2020. When setting up the fund, international developments should be taken into account.