



Use of the bail-in tool

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2. Summary

When Danish banks experience a crisis, the situation will be handled in accordance with the common European rules on resolution as laid down in the Banking Recovery and Resolution Directive (BRRD). In Denmark, Finansiel Stabilitet and the Danish FSA are jointly appointed as the resolution authority, with Finansiel Stabilitet being the party taking control of failing banks. This is part of the crucial task of ensuring that the critical functions of the banks are upheld, providing customers with continued access to their deposits and loan facilities.

Under the guidelines of the European Banking Authority (EBA), the resolution authority of each EU member state must publish a general description of their approach to write-down and conversion (bail-in). For this purpose, Finansiel Stabilitet and the Danish FSA have jointly prepared a paper on the use of the bail-in tool.

The paper does not contain any changes to the existing Danish practice, described in Finansiel Stabilitet's annual reports over the years, but it sets out the current preferred resolution strategies for Danish banks involving planned use of the bail-in tool. In Denmark, bail-in or variations thereof have been used for crisis management of several Danish banks since 2011. As the bail-in tool does not apply to mortgage credit institutions, the paper only concerns banks.

For SIFIs¹, the bail-in tool is generally used with a view to rendering the institutions viable (restructuring), whereas for non-SIFIs a controlled winding up of activities is carried out. The paper focuses on the use of bail-in on SIFIs.

The paper describes the four phases of crisis management of a failing bank, i.e. recovery of the bank, active crisis management, the restructuring phase and the final phase.

As the resolution authority, Finansiel Stabilitet has the power to apply a number of resolution measures and resolution tools for active crisis management purposes. As these powers affect the bank and its shareholders and creditors quite extensively, it is a requirement that Finansiel Stabilitet has assessed that the conditions for resolution are met. Which creditors/liabilities of the failing bank which are to be subject to bail-in in the specific situation depends on ranking of the liability in the creditor hierarchy and the extent of the need for write-down and conversion. In this context, Finansiel

¹ The abbreviation is short for *systemically important financial institution*.



Stabilitet must ensure that no creditors are worse off than they would have been if the bank had been administered in bankruptcy.

Write-down and conversion take effect from the date on which Finansiel Stabilitet notifies the failing bank of the decision to write down or convert the bank's shareholders and creditors/liabilities.

Crisis management of banks in Denmark is based on the fundamental principle that it must be carried out in a fair manner and must be in the interest of the general public. It is also essential that losses inflicted on taxpayers etc. are mitigated.

3. Introduction

In the wake of the financial crisis, the EU developed a harmonised set of rules for the resolution of credit institutions. The rules, which came into force in 2015, are intended to ensure uniform and efficient crisis management of failing banks and mortgage credit institutions (credit institutions). The crisis management procedure is aimed at ensuring continuity of the bank's critical financial and economic functions and preventing instability in the financial markets. Moreover, the rules imply that, to the extent possible, the taxpayers are not left with the bill for cleaning up distressed banks, and that the bank's shareholders and creditors will bear the costs. In addition, the sector can contribute in connection with the use of deposit guarantee schemes.

In Denmark, the Danish Financial Supervisory Authority (FSA) and Finansiel Stabilitet share the responsibility for resolution (and are collectively referred to as the resolution authority). The Danish FSA is the resolution authority until the point in time when the credit institution fails (going concern). The assessment of whether a credit institution is failing also lies with the Danish FSA. If an institution is identified as failing, then Finansiel Stabilitet will become the resolution authority and will carry out the actual resolution measures (gone concern). Denmark's Nationalbank, the central bank of Denmark, acts as the consultee of systemically important financial institutions (SIFIs). In addition, the Danish Minister for Industry, Business and Financial Affairs must approve the choice of resolution tools to be applied to SIFIs.

SIFI refers to an institution that is considered particularly important for the economy to the extent that additional rules must be imposed on it, including, for example, additional capital requirements.



The failure of a systemically important institution could have significant adverse effects on the functioning of financial markets, with the risk of a contagion effect on other financial institutions and a negative impact on market confidence and the real economy. The Danish FSA identifies the Danish and North Atlantic SIFIs on an annual basis².

The resolution authority must prepare resolution plans for all Danish and North Atlantic credit institutions. However, in a resolution situation, Finansiel Stabilitet is not obliged to follow the chosen resolution strategy if other resolution measures are considered more appropriate in the specific situation.

In a resolution situation, a number of different parties may need to be involved. The ex-ante resolution planning will take into account coordination and the need for the involvement of these parties. These parties may be, for example, the credit institution under resolution, other relevant authorities and players from financial market infrastructures (data centres, securities trading venues, etc.). For groups with foreign activities (also known as cross-border groups), resolution colleges have been established in which relevant authorities of the countries in which the groups operate will jointly plan the resolution.

From the time when a bank is found to be failing to the time resolution is completed, Finansiel Stabilitet has a number of powers, including the possibility to use different resolution tools such as the bail-in tool. Finansiel Stabilitet may use bail-in to absorb losses and to recapitalise a bank. Bail-in consists of write-down of creditors/liabilities and/or conversion of debt into equity and may be used in isolation or in combination with other resolution tools. In Denmark, bail-in or variations thereof have been used for crisis management of Danish banks since 2011. In the Danish and North Atlantic resolution plans for banks, bail-in is the preferred resolution tool.

For SIFIs, bail-in is generally used in order to render the institutions viable again (restructuring), whereas for non-SIFIs a controlled winding up of activities is carried out. In the following, focus will be on the crisis management of SIFIs.

² The Faroe Islands and Greenland.



The actual implementation of write-down and conversion using the bail-in tool will depend on the specific situation. Hence, the handling of the actual resolution may differ from what is described in this paper.

This paper is a non-exhaustive description of the process of bail-in. It provides an overview of the phases of crisis management of a failing bank (section 3) and explains the powers of the resolution authority (section 4) and the practical application and effect of the measures taken by the resolution authority (sections 5 and 6).

However, a resolution process also involves a number of different activities and measures which are not described in this paper. As the bail-in tool does not apply to mortgage credit institutions, these institutions are excluded from this description, and in the following the focus is only on banks.

The paper will refer, as appropriate, to the relevant legislation; primarily the Danish Financial Business Act (the “FBA”) and the Danish Act on Restructuring and Resolution of Certain Financial Enterprises (the “RRA”).

4. Timeline for crisis management

The crisis management of a bank may be divided into four phases: recovery of the bank, active crisis management, the restructuring phase and the final phase. The specific crisis management process will not necessarily cover all four phases.

Figure 1: Phases of crisis management



During the **recovery phase**, a bank in crisis will experience significant operating losses, and its survival will be called into question. In this situation, the bank is still controlled by its existing



shareholders, management, etc., but the Danish FSA may exercise its powers to intervene early in parallel with the bank's own recovery efforts if this will help to restore the financial position of the bank, see part 15a of the FBA. If the measures have no effect, the Danish FSA may, upon consulting Finansiel Stabilitet, decide that a bank is failing or likely to fail (FOLTF), see section 224a(1) of the FBA. A decision on FOLTF presupposes that the Danish FSA sees no prospect of other solutions saving the bank. When the Danish FSA has declared a bank to be FOTLF, the bank will be transferred to Finansiel Stabilitet as the resolution authority, and the existing shareholders, management, etc. no longer have control over the bank.

Active crisis management begins when Finansiel Stabilitet assesses that the resolution of the bank is in the public interest, see section 5 of the RRA. Finansiel Stabilitet will determine a provisional valuation and appoint an independent valuer to perform a final valuation. See section 4.2. for more detailed information on the valuation process. Once Finansiel Stabilitet has taken control of the bank, trading in the bank's shares and relevant bonds will be suspended if this has not already happened. Finansiel Stabilitet will also appoint a new management.

Subsequently, Finansiel Stabilitet will decide which resolution measures should be implemented. The use of resolution tools for systemically important institutions is subject to approval by the Danish Minister for Industry, Business and Financial Affairs. On the basis of the provisional valuation, Finansiel Stabilitet will determine the extent to which shares and liabilities are to be written down.

When the final valuation is available, final resolution measures will be implemented. This may imply that shareholders and creditors who were subject to write-downs based on the provisional valuation may subsequently have the write-down adjusted and/or have parts of the write-down converted into share capital, depending on their ranking in the creditor hierarchy (see figure 2). Conversions will generally be carried out on the basis of the final valuation only.

In addition, it must be determined whether additional resolution measures, other than bail-in, should be applied, including a provision of liquidity.

During the **restructuring phase**, following the active crisis management, the independent valuer will complete the final valuation. Subsequently, final write-down and conversion of shares and liabilities will be carried out based on the final valuation. The new shareholders who, upon the transfer of the



bank, acquire a qualifying holding³ must be approved by the Danish FSA pursuant to section 61 of the FBA.

When no further resolution measures are required, and the bank is deemed to be able to stand on its own feet again, the **final phase** commences, in which the bank will be handed back to the new shareholders. This completes Finansiel Stabilitet's resolution of the bank.

The duration of the restructuring phase will depend on the time spent by the independent valuer on completing the final valuation, but should be expected to extend over several months, depending on the complexity of the failing bank.

Although the bank has been transferred to new shareholders, the implementation of certain resolution measures may still be ongoing. This concerns in particular the new management's implementation of the restructuring plan.

The following sections describe the different elements of resolution involving the bail-in tool.

5. Resolution powers and principles

Finansiel Stabilitet, as a resolution authority, has the power to use a number of resolution measures and resolution tools. As these powers affect the bank and its shareholders and creditors quite extensively, it is a requirement that Finansiel Stabilitet has assessed that the conditions for resolution are met, see section 4 of the RRA. In summary, the institution must be assessed to be FOLTF by the Danish FSA and, upon consulting Finansiel Stabilitet, there must be no prospect of the bank being able to avoid resolution by other measures, and resolution must be in the public interest.

Consequently, Finansiel Stabilitet cannot implement any resolution measure(s) until the bank meets the resolution conditions. In selecting and exercising those powers, Finansiel Stabilitet will take into consideration the resolution objectives set out in section 5 of the RRA. In brief, the objectives are as follows: Finansiel Stabilitet must choose the tools and powers that best achieve following objectives:

³By qualifying holding is meant direct or indirect ownership of at least 10% of the share capital or voting rights, or a holding which allows the holder to exert significant influence on the management of the financial enterprise or the financial holding company.



the continuation of critical functions, prevention of financial contagion, protection of depositors and customers and minimisation the use of public funds.

5.1. Finansiel Stabilitet's exercise of control over the bank

When Finansiel Stabilitet takes on a bank which is assessed by the Danish FSA to be FOLTF, Finansiel Stabilitet may exercise full control over the bank. This is done by Finansiel Stabilitet assuming the powers conferred upon the bank's shareholders and board of directors, who will no longer have the right to exercise their powers during the same period⁴. The powers are taken over from the date of Finansiel Stabilitet's decision to exercise control over the bank. When Finansiel Stabilitet has decided to exercise control over a bank, notification of the decision will be given in the IT system of the Danish Business Authority. Once Finansiel Stabilitet has taken control, the name of the bank will be changed to indicate the change of control. Decisions made by Finansiel Stabilitet will have the same effect as if the decision had been made by the bank controlled by Finansiel Stabilitet. The authorisation to exercise control over the bank will apply during the active crisis management phase and throughout the restructuring phase until Finansiel Stabilitet has given notification of a decision to cease exercising control over the bank in the IT system of the Danish Business Authority⁵.

5.2. Valuation for the purpose of decisions on write-down and conversion

As part of its resolution measures, Finansiel Stabilitet appoints an independent valuer to perform a number of valuations and prepare a valuation report, see sections 6–8 of the RRA.

The purpose of the initial valuation is to assess whether the conditions for resolution are met for the bank (valuation 1). The valuation is based on a general going concern principle, implying that the activities of the bank are assessed based on fair and realistic assumptions. The purpose of the valuation is to assess the financial position of the bank immediately prior to the bank being assessed as failing.

The second valuation (valuation 2) provides the basis for the choice of resolution measures, including the calculation of, among other things, the write-down to be performed on the capital instruments and liabilities of the bank. This valuation must include a fair, prudent and realistic valuation of the

⁴ See section 15 of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.

⁵ Danish Executive Order on Resolution Measures.



assets and liabilities of the bank. The difference between valuations 1 and 2 is best described as a precautionary principle being incorporated into the latter.

By way of conclusion, the independent valuer must assess whether shareholders and creditors are worse off than they would have been if the institution had been wound up under normal insolvency proceedings (valuation 3). If this is the case, they are entitled to receive the difference from the Resolution Fund. This principle is referred to as *no creditor worse off* (NCWO).

The valuations carried out cannot become subject to separate judicial review but may be reviewed solely in conjunction with Finansiel Stabilitet's implementation of resolution measures.

Finansiel Stabilitet will make use of the option to carry out a provisional valuation of the assets and liabilities of the bank, including a provisional valuation 1 and valuation 2. Furthermore, when Finansiel Stabilitet applies a provisional valuation, a buffer is included to ensure that the provisional valuation 2 is more prudent than the final valuation 2 which is subsequently completed by the independent valuer. All other things being equal, this will ensure that there is no excessive distribution of assets in the first round, in which the resolution measures of Finansiel Stabilitet are based on a provisional valuation.

5.3. Discontinuation or suspension of securities trading

In connection with the resolution of a bank with listed securities, trading in the bank's shares and listed bonds will be suspended either before or at the latest during the crisis management phase conducted by the authorities. This will be either the result of the bank's own actions before crisis management is carried out, or it will occur when Finansiel Stabilitet takes control.

6. Write-down and conversion of shares and liabilities

When Finansiel Stabilitet has taken control of a bank, and Finansiel Stabilitet has assessed that the conditions for resolution are met, resolution measures may be implemented, including the bail-in resolution tool.



6.1. Description of the bail-in resolution tool

Finansiel Stabilitet may use the bail-in tool to absorb losses and to recapitalise a failing bank. A condition for the use of bail-in on unsubordinated creditors is that shares are fully written down and that all subordinated debt is written down and/or converted into common equity tier 1 instruments pursuant to sections 17 and 18 of the RRA. In other words, the subordinated liabilities at the top of the creditor hierarchy must be written down before it is possible to move further down the creditor hierarchy (see section 5.2. and figure 2). Bail-in may be applied to all senior liabilities of the bank, including provisions, except those exempted from bail-in⁶, and subordinated liabilities which have not been written down or converted pursuant to sections 17 and 18 of the RRA.

In order to be able to use bail-in for the recapitalisation of a bank, it must reasonably be expected that recapitalisation, in addition to meeting the relevant resolution objectives, will lead to a restructuring of the bank in order to ensure long-term viability.

6.2. Creditor hierarchy in connection with bail-in

The order of priority for write-down and conversion is consistent with the order of priority applied in bankruptcy proceedings, see sections 93–98 of the Danish Bankruptcy Act, taking into account the special bankruptcy provisions set out in section 13 of the RRA. Some liabilities are exempt from bail-in, see section 25(3) of the RRA, including covered deposits. By covered deposits is meant deposits which are subject to the Danish Act on a Depositor and Investor Guarantee Scheme, including, for example, deposits covered by the Guarantee Fund up to a maximum limit of EUR 100,000, or approximately DKK 745,000.

In addition, Finansiel Stabilitet may specifically exempt individual or several categories of liabilities from bail-in pursuant to section 25(4) of the RRA; for example, if necessary for the continuation of functions critical to society or to avoid a contagion effect on the financial markets. However, it is expected that no liabilities will be extraordinarily exempted from bail-in other than those already ordinarily exempted by legislation⁷.

⁶ Section 25(3) and (4) of the Danish Act on Restructuring and Resolution of Certain Financial Enterprise provide exemptions for bail-in.

⁷ The ordinary exemptions for bail-in are set out in section 25(3) of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.



When exercising its write-down and conversion powers, Finansiel Stabilitet distributes losses equally between shares and liabilities of equal ranking in the creditor hierarchy. Such equal distribution is generally achieved by writing down the amount in question to the same extent for all creditors in the group of creditors. However, this principle is derogated from in the case of liabilities exempted from bail-in. Thus, shares will bear losses first, followed by other capital instruments in their order of priority under the agreed terms. Subsequently, other liabilities will bear losses in accordance with the creditor hierarchy.

Figure 2: Overview of the creditor hierarchy in connection with bail-in





6.3. Effect of write-down of shares

Finansiel Stabilitet may cancel existing shares, transfer them to creditors or dilute existing shareholders⁸.

Finansiel Stabilitet will as soon as possible notify each of the existing shareholders whose shares are written down of the measures taken. Non-receipt of such individual notification will not influence the legal effect of the measures taken⁹. The notification must be given when a decision has been made to take measures based on the provisional valuation and in the event of any further or changed measures as a result of the final valuation. Finansiel Stabilitet will update the register of shareholders of the bank as well as the register of shareholders kept by the Danish Business Authority.

6.3.1. Cancellation of existing shareholders

Finansiel Stabilitet may decide to cancel existing shares in case of a capital reduction¹⁰. This may be combined with a capital increase where new shares are issued to creditors whose claims have been converted¹¹.

The Danish Minister for Industry, Business and Financial Affairs has laid down detailed rules on the implementation of certain measures, including the cancellation of shares, in the Danish Executive Order on Resolution Measures. The Executive Order derogates from a number of formal requirements following from parts 10 and 11 of the Danish Companies Act during the critical phase. A decision to reduce capital or increase capital must still comply with the requirements of sections 159 and 188 of the Danish Companies Act subject to any derogations provided for in the Executive Order. Moreover, Finansiel Stabilitet may transfer shares from a shareholder to the person who by way of conversion is to be the new shareholder. Accordingly, it is possible to transfer the ownership without the consent of the previous shareholders.

⁸ See section 46 of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.

⁹ See section 16 of the Danish Executive Order on Resolution Measures.

¹⁰ See section 44(1)(i) of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.

¹¹ Danish Executive Order on Resolution Measures.



6.3.2. Dilution of existing shareholders

Finansiel Stabilitet may furthermore dilute existing shares¹². By dilution is meant that new shares are issued to persons other than the existing shareholders, to the effect that their proportionate share of the issued instruments is reduced. Finansiel Stabilitet may adopt changes in the share capital which, in a bank not under resolution, would normally be subject to the approval of the shareholders in a general meeting.

The existing shareholders will, if diluted, retain a small part of their rights and the value of the share capital. A precondition for dilution is that the valuation based on the final valuation has a positive net asset value, see part 3 of the RRA.

In this context, dilution will be affected by a conversion of relevant capital instruments in accordance with the rule on write-down and conversion of relevant capital instruments set out in section 17 of the RRA, i.e. by conversion of the subordinated liabilities in the upper part of the creditor hierarchy, or by conversion with bail-in, see section 24 of the RRA.

6.3.3. Application of conversion rates

When Finansiel Stabilitet carries out conversions, different conversion rates may be applied depending on the ranking of the liability in the creditor hierarchy¹³. By conversion rate is meant the rate at which the liability is converted into common equity tier 1 capital (shares).

The conversion rate applied must represent appropriate compensation to the affected creditor for any loss incurred by virtue of the exercise of the conversion powers. Such appropriate compensation is determined on the basis of the final valuation under the RRA. It must reflect that shareholders and creditors of the bank are to bear the losses while at the same time not incurring greater losses than they would have incurred in bankruptcy proceedings, due to the NCWO principle. When different conversion rates are applied, the conversion rate applicable to senior liabilities in the creditor hierarchy must be higher than the conversion rate applicable to subordinated liabilities.

¹² See section 44(1)(ii) of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.

¹³ See section 45 of the Danish Act on Restructuring and Resolution of Certain Financial Enterprises.



7. When does bail-in take effect?

Write-downs and conversions take effect from the time when they are implemented by Finansiel Stabilitet. That is, from the time when Finansiel Stabilitet notifies the failing bank that a decision has been made to write down or convert the relevant capital instruments of the bank or to implement a bail-in for the relevant creditors. Thus, the write-down and the conversion are immediately effective for and binding on the bank and the shareholders and creditors concerned. This has a direct effect and does not require any changes to the individual loan terms etc.

If a liability is fully written down by Finansiel Stabilitet, that liability or claims related thereto will be treated as having been resolved in all respects. If Finansiel Stabilitet writes down a liability in part, the liability will be resolved to the extent of the amount written down. The relevant instrument or the relevant agreement underlying the original liability will continue to apply in relation to the residual principal amount of the liability or the outstanding amount to be paid in relation to the liability. Accordingly, the loan terms for the part of the liability not written down are generally not changed. However, going forward, the agreements must respect any change in the interest amounts accrued to reflect the write-down and any further amendments to the terms and conditions made by Finansiel Stabilitet under part 5 of the RRA. Among other powers, Finansiel Stabilitet may cancel or amend the terms and conditions of contracts entered into by a bank under resolution if necessary, in order to ensure the implementation of resolution measures.

Write-down and conversion may be carried out by bail-in either in isolation or in combination with other resolution tools. Moreover, in a resolution situation, Finansiel Stabilitet may apply the following resolution tools: a sale of the business, a bridge institution and separation of assets. How the resolution objectives are best ensured depends on the specific resolution setting. (The specific resolution setting determines the concrete way of best ensuring the resolution objectives.)