RIKSGÄLDEN

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FINANCIAL CRISIS MANAGEMENT

The Swedish National Debt Office's work on financial stability

The Debt Office's role in financial crisis management

The Swedish National Debt Office is responsible for dealing with banks and other institutions that run into difficulty. This publication presents the Debt Office's role in financial crisis management and its work on maintaining financial stability.

The Debt Office operates three different functions in the context of financial crisis management:

- Resolution – the procedure for managing failing institutions that are systemically important.
- Deposit insurance – the public guarantee for bank deposits.
- Precautionary support – temporary public support to viable institutions.

These schemes have the common goals of promoting financial stability and protecting depositors.

As Sweden's resolution authority, the Debt Office is responsible both for preparing for crises in banks and for managing them. *Resolution* is where the government assumes control of a troubled institution that is considered systemically important in order to restructure it or wind it down in an orderly manner. In this process, all or parts of the institution remain open so that depositors and other customers can access their accounts and other services. Losses are borne by the institution's shareholders and creditors (known as "bail-in"). In this way, taxpayers do not foot the bill for managing the crisis.

Deposit insurance is ultimately a form of consumer protection, but is also important for financial stability. The scheme applies whichever way a failing institution is dealt with – the protection for depositors is the same in the case of bankruptcy as it is with resolution. The Debt Office's role covers everything from providing information about the scheme to paying out compensation as necessary.

The Debt Office is also responsible for the *precautionary support* that the government may provide on a temporary basis to institutions that are fundamentally viable. This might, for example, be granted in the event of general turmoil in financial markets.

The Debt Office's role in financial crisis management is not limited to institutions formally organised as banking companies. The various rules also cover credit market companies, savings banks, members banks, investment firms and, in certain cases, some other types of company. For this reason, the terms banks and other institutions are used in this publication.

Preface

Financial crises are among the most costly things that can happen to a society. We have seen this throughout history, with crises triggered by everything from tulip bulbs to railroad stocks and unsustainable levels of public and private indebtedness. Whichever way each individual crisis has panned out, the consequences for public finances, firms and households have often been severe and lasting.

The most recent example is the global financial crisis that erupted in 2008. Back then, the crisis management systems in many countries consisted solely of deposit insurance schemes, and Sweden was no exception. In practice, therefore, governments had only two options to choose between: allow banks to fail and risk serious consequences for the economy, or bail them out with large amounts of taxpayers' money.

In Sweden, the Debt Office worked together with the government, the financial supervisory authority and the central bank to manage the crisis. The Debt Office issued guarantees and injected capital into viable banks. It also handled the special support granted to Carnegie and issued additional treasury bills to ensure that the markets continued to function.

Internationally, the lesson learned was that we needed ways of dealing with failing banks without taxpayers having to foot the bill. In the years after the crisis, principles were therefore developed at a global level for how future crises should be handled.[1] These principles went on to form the basis for more detailed rules adopted by the EU in 2014 known as the Bank Recovery and Resolution Directive (BRRD).[2] In 2016, the Debt Office was given responsibility for the new resolution regime in Sweden.

Resolution means that governments will no longer rescue banks using taxpayers' money. Instead, banks' shareholders and creditors are to bear all of the costs that bank's operations might bring, while keeping the business going. Dealing with failing banks efficiently will also reduce the economic damage that financial crises inevitably cause.

The matter of how a crisis can best be tackled depends ultimately on two factors: whether there is a risk of the crisis causing serious disruption in the financial system, and whether the troubled institution is considered viable. Banks and other institutions that are systemically important are to be placed into resolution. Others are to be placed into bankruptcy or liquidated. Whichever procedure the Debt Office decides on, depositors will always be covered by the deposit insurance scheme.

The aim of this publication is to give the reader an understanding of the different crisis management methods now available in Sweden if a bank or other institution should find itself in a financial crisis.

Hans Lindblad
Director General

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[1] *Financial Stability Board (2011), "Key Attributes of Effective Resolution Regimes for Financial Institutions", http://www.fsb.org/wp-content/uploads/r_111104cc.pdf.*

[2] *Directive 2014/59/EU of 15 May 2014. See footnote 4 for its full designation.*

Contents

Summary

- Financial crisis management is an important part of the work in safeguarding financial stability and protecting the economy from the costly effects that a financial crisis can have.
- There are two reasons why special systems are needed to deal with banks and other institutions in crisis. One is that they provide functions that are crucial for a properly functioning economy. The other is that their operations feature an inherent degree of instability. This means that banks cannot routinely be allowed to fail in the same way as other types of companies.
- If a crisis arises at a Swedish institution, the Debt Office is responsible for handling the situation. The approach it takes will depend on which institution it is, and what form the crisis takes.
- Institutions that are considered crucial for the functioning of the financial system, known as "systemically important", are to be dealt with in a process called "resolution". Other institutions are placed into bankruptcy or liquidated. The deposit insurance scheme will always apply regardless of whether the crisis is managed via bankruptcy, liquidation or resolution. In some circumstances, the Debt Office can also provide precautionary support to viable systemically important institutions.
- Resolution enables the government to act quickly and decisively to deal with crises as they arise, so minimising their harmful effects. Resolution means that it is shareholders and creditors who bear the direct costs of an institution failing. This involves a process called "bail-in", whereby shareholders and creditors have their holdings written down to zero or converted into equity.
- The resolution regime reduces the incentive for shareholders and other creditors to allow a bank to take excessive risks. This will help reduce the risk of a crisis arising in the first place.
- To further ensure that the financial sector bears the direct costs of financial crises, special funds and reserves that are financed by the institutions themselves have been set up. These are being built up gradually before crises occur by the Debt Office charging institutions annual fees. There are three arrangements of this kind in Sweden: a resolution reserve, a deposit insurance fund, and a stability fund.
- Effective crisis management requires extensive planning and preparation. The Debt Office carries out crisis planning for all institutions, whether or not they are systemically important. Key parts of this work include drawing up resolution plans, assessing whether the proposed crisis management measures are feasible, and deciding on the minimum requirement of own funds and eligible liabilities (MREL).
- The preparatory work, on both resolution and deposit insurance, involves close collaboration with other national and international authorities and bodies.

Financial crisis management crucial for financial stability

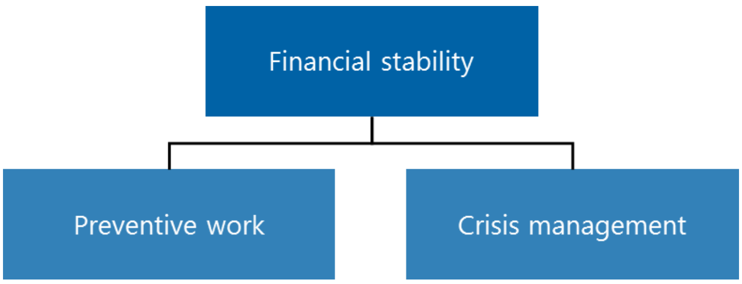
Crises in the financial system can be very costly for society. The risk of a crisis occurring, however, can be reduced through preventive action. With the new regime for managing crises through resolution, the government can act quickly and decisively to deal with crises as they arise and in a way that limits the costs. Rather than having the government – and ultimately the taxpayer – bear the cost of banking crises, the new system means that it is shareholders and creditors who foot the bill. The Debt Office is responsible for managing any crises that arise at banks and other institutions in Sweden.

Financial stability key to a functioning economy

Financial stability means that the financial system can maintain its fundamental functions and is resilient to disruptions that threaten these functions.[3] These fundamental functions are to facilitate payments, turn savings into financing, and manage financial risks. These functions are important for the economy to function effectively.

Serious disruption to any of these fundamental functions can have considerable costs for society, so there is a need to maintain financial stability. This can take the form of preventive measures to reduce the risk of a crisis occurring, and crisis management measures to limit the costs when one does (see Figure 1).

Figure 1. Work on financial stability



[3] *There are various ways of defining financial stability. The Debt Office has decided to define it in this way in the light of work by Sveriges Riksbank and the International Monetary Fund (IMF). See Sveriges Riksbank (2014), "The Riksbank and financial stability", and Schinasi, G. (2004), "Defining Financial Stability", IMF Working Paper WP/04/187.*

Preventive measures reduce the risk of crises

Financial stability is needed for a well-functioning economy, but the financial system is inherently sensitive. Banks are vulnerable because they lend money over long periods (e.g. mortgages) and fund these loans by borrowing over short periods (e.g. deposits from the public). This creates an imbalance between long-term assets, which are illiquid, and short-term liabilities. If a bank's ability to pay its debts is called into question, confidence in the bank can quickly evaporate, with the result that it is no longer able to source funding.

The various parts of the financial system are also closely interconnected – for example, through investments in one another's bonds. This means that problems emerging in one part of the system quickly can spread to other parts and threaten financial stability. It may therefore be difficult to isolate a crisis in one specific bank without contagion to other banks. Furthermore, many banks are very large and can present substantial concentration risks on their own.

Therefore, structures which reduce the risk of financial disruption are needed. This is the aim of preventive measures on financial stability. This might, for example, mean building resilience into the system by ensuring that banks have sufficient capital and liquidity reserves. These and other rules and principles help keep risk-taking at economically sustainable levels.

Effective crisis management reduces costs to society

Even if resilience is built up through preventive measures, problems may still arise that could threaten financial stability. For example, this might happen if a bank breaks the rules put in place, or if external events spark turmoil in financial markets and cause investors to stop lending to banks. To safeguard financial stability and protect the financial system's fundamental functions even in such a situation, the government needs to have systems in place to deal with banks and other institutions that find themselves in trouble.

Historically, there have been no such systems. Governments have therefore had to intervene repeatedly with taxpayers' money to cover losses and inject capital into banks in order to reduce the risk of a crisis spreading. Both the direct and indirect costs of these types of rescues have often been very high. The direct costs are the immediate costs that the government incurs in bailing out the bank. Indirect costs, are the effects on public finances which arise through reduced GDP, investments and employment in the wake of a financial crisis.

As governments have repeatedly bailed out banks that have run into problems, an expectation has arisen that they will always step in. This has led to banks often taking greater risks and obtaining cheaper funding than their business would warrant. This is because their creditors faced no risk of losing their money if the bank failed, resulting in harmful incentives that undermined the functioning of the financial system.

Resolution is the new regime to tackle these problems.[4] It gives the government tools to act quickly and decisively to deal with crises as they arise and so reduce their damaging effects. Resolution means that shareholders and creditors bear the direct costs of a crisis. This in turn creates a greater awareness of the bank's risks among shareholders and creditors, which will ultimately help reduce the chances of a crisis occurring.

Shared responsibility for financial stability in Sweden

In Sweden, the Ministry of Finance, Finansinspektionen (the financial supervisory authority), Sveriges Riksbank (the central bank) and the Debt Office have a joint responsibility for keeping the financial system stable. These authorities have different roles and responsibilities, but co-operation between them is crucial for both preventing and managing crises. These roles are as follows:

- The *Ministry of Finance* is responsible for drawing up laws and regulations concerning the financial system (often based on EU rules). The ministry and the government have an overall responsibility for crisis management and co-ordination. The government must also approve some of the underlying authorities' decisions on macroprudential supervision and crisis management.
- *Finansinspektionen* is responsible for supervising institutions. The supervision can be either specific to each institution (microprudential supervision) or system-wide (macroprudential supervision). One key part of this is ensuring that institutions are sufficiently resilient, for example by setting capital adequacy requirements.
- The *Riksbank* is responsible not only for price stability but also for promoting a safe and efficient payment system. To achieve this, the central bank can supply liquidity to the financial system as a whole and, in exceptional circumstances, to individual institutions.
- The *Debt Office* is responsible for managing financial crises that arise at banks and other institutions and for preparing for crisis management. This includes responsibility for resolution, precautionary support and deposit insurance.

Whether these organisations' responsibilities lean more towards crisis prevention or crisis management, there are clear interfaces, making co-operation essential both in the planning process and in a crisis.

The Financial Stability Council has been set up to promote collaboration on matters concerning financial stability. It constitutes a forum for representatives of the government and the authorities to discuss the stability situation and the need for preventive measures to tackle financial imbalances. In the event of a financial crisis, the council will meet more frequently to discuss what action is needed to deal with the situation. The council does not, however, take any decisions. The government and the authorities do so independently within their respective areas of responsibility.

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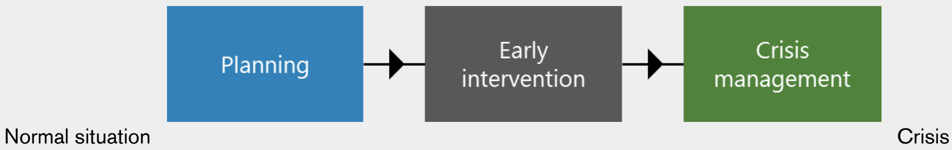
[4] *See the Bank Recovery and Resolution Directive (BRRD): Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.*

From planning to crisis management

Effective crisis management requires not only appropriate mandates and tools but also proper contingency planning. How the work from planning through to crisis management is to be conducted is laid down in law and involves Finansinspektionen, the Debt Office, the Riksbank, the government and the institutions concerned. Somewhat simplified, this work breaks down into three phases, as shown in Figure 2.

Figure 2. From planning to crisis



Planning essential for effective crisis management

Effective crisis management requires prior preparation and planning. Both the institutions and the authorities carry out extensive preparation and planning work.

Each institution draws up a *recovery plan*. This details the actions the institution plans to take to preserve or restore its financial position and viability following a deterioration in its financial situation. The recovery plan is a preventive measure intended to help prevent an institution from failing. Finansinspektionen is responsible for assessing these plans and may, where necessary, order the institutions to improve them.

The Debt Office in turn draws up a *resolution plan*. This sets out the actions that it plans to take if the institution's financial problems are so serious that the conditions for resolution are met. The resolution plan can be said to come into play where the recovery plan leaves off. Resolution planning is described in more detail in the section *Preparing and planning for a crisis*.

Early intervention to prevent a crisis

Early intervention refers to the crisis prevention measures that Finansinspektionen can take to stop problems at an institution from becoming so serious that it fails. Finansinspektionen can, for example, require an institution to make strategic, organisational or leadership changes, or to take the actions set out in its recovery plan. This might mean ordering the institution to strengthen its own funds or liquidity. In practice, crises often take very different forms, which may imply that this phase will be short-lived and that the crisis management phase has to be initiated at short notice.

Crisis management

If an institution's problems become so serious that it is no longer viable, the Debt Office needs to decide which crisis management method is most appropriate. Systemically important institutions are dealt with through resolution. Institutions that are not systemically important are allowed to go into bankruptcy. Customer deposits are insured whichever crisis management procedure is chosen. In the event of general financial turmoil, there may be a case for providing precautionary public support to viable institutions.

Decisions on the actions to be taken by the Debt Office are made by the Resolution Board (see the box *Special decision-making body for financial crisis management*).

The Debt Office's responsibilities in the event of a crisis

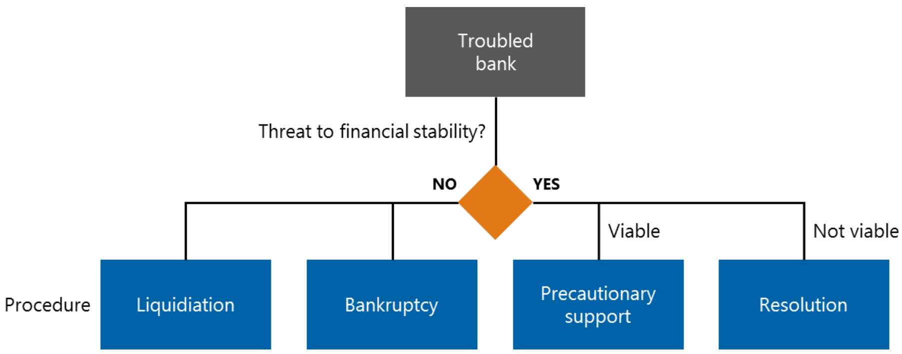
Should a crisis arise at a bank or other institution, the Debt Office is responsible for handling the situation. The appropriate approach will depend on which institution it is, and what form the crisis takes. Institutions that are considered systemically important are managed through resolution. Others are to be placed into bankruptcy or liquidated. The deposit insurance scheme applies whichever crisis management procedure is chosen. In some circumstances, the Debt Office can also provide precautionary support to viable systemically important institutions.

Crisis management method depends on institution's type and viability

In a situation where a bank or other institution runs into problems, there are a number of different options available to both the authorities and the institution itself to deal with the situation. The following presents the procedures and tools for which the Debt Office is responsible, and the circumstances in which they might be used.

The decisions that need to be made are based on a variety of different considerations, and to some extent the different processes run in parallel. Somewhat simplified, however, the main choices that the Debt Office has to make in handling a crisis at a troubled institution can be summarised as shown in Figure 3.

Figure 3. Illustration of different crisis management procedures



Does winding-down pose a threat to financial stability, and is the institution viable?

If an institution has such serious problems that steps taken by Finansinspektionen or the institution itself are no longer enough to stabilise the situation, Finansinspektionen is to hand over the responsibility to the Debt Office (see box *From planning to crisis management*). The institution is then classified as failing or, in Finansinspektionen's opinion, likely to fail.

The Debt Office's first task is to determine whether or not the institution is systemically important. This means identifying whether the institution provides functions that can be considered critical for the functioning of the financial system, and whether allowing the institution to fail might cause the crisis to spread to other parts of the financial system.

Critical functions are services that, if the institution stopped providing them, would probably lead to serious disruption in the financial system. Accepting deposits from the public and issuing mortgages are examples of functions that could be considered critical. Others might be lending to businesses or managing their deposits. For a function to be considered critical, it needs to account for a certain share of the overall market.

When assessing whether allowing an institution to fail might cause the crisis to spread to other parts of the financial system, the Debt Office considers what effect its bankruptcy or liquidation would have on other institutions' ability to provide critical functions. There might, for example, be potential contagion effects in financial markets due to concern among investors.

If the failing institution is not systemically important, it will be placed into bankruptcy or liquidated. If, on the other hand, the institution is indeed deemed systemically important, the Debt Office will place it into resolution. The deposit guarantee scheme applies whichever crisis management procedure is chosen.

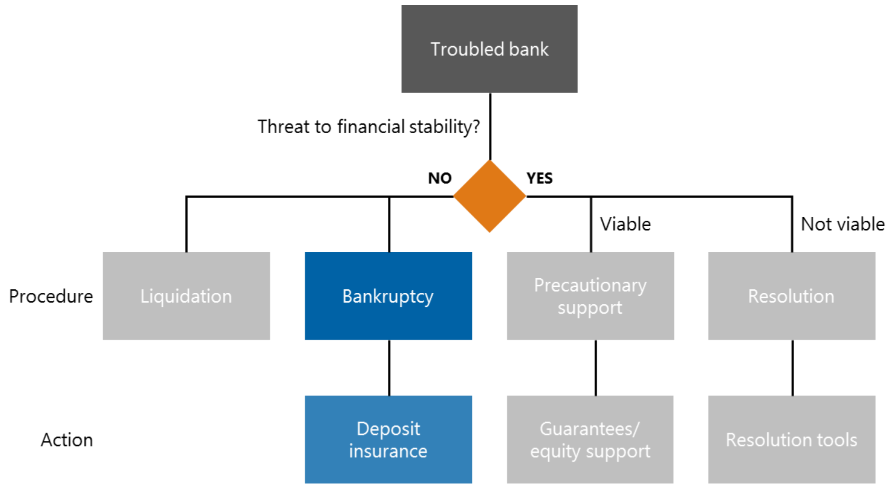
The Debt Office carries out extensive planning and has an individual crisis management plan pre-prepared for every single Swedish institution. However, it cannot be ruled out that the circumstances in an acute situation have changed, or that circumstances which could not be foreseen in the planning process have emerged. The actual management of the crisis may then differ from what was envisaged in the planning phase. The default approach nevertheless will be the one identified in advance.

If there is a threat of serious disruption in the financial system, the Debt Office may provide precautionary support to viable systemically important institutions. A viable institution is one that still meets the terms of its licence, has a long-term sustainable financial position, and whose operations and business model remain sound. Public support of this kind is intended to provide temporary assistance for an institution running into limited problems, and so is not expected to entail any cost to the government in the longer run. Various conditions must be met before precautionary support can be provided – for example, it must comply with EU state aid rules. It should be noted that precautionary support is not an alternative to resolution, as these are two separate procedures that are used in different circumstances.

Bankruptcy and activation of deposit insurance

If the Debt Office believes that an institution's failure will not threaten financial stability, it will be placed into bankruptcy or liquidated. If it is placed into bankruptcy, the Debt Office's task is to make depositors' funds available within seven working days. The deposit insurance may also be activated if Finansinspektionen concludes that an institution is not in a position to repay deposits and where the situation is not only temporary.

Figure 4. Troubled bank that is not systemically important



Note. The deposit insurance scheme applies whatever the procedure, but will only be activated if an institution is placed into bankruptcy or if Finansinspektionen concludes that an institution is not in a position to repay deposits and that this situation is not only temporary.

The deposit insurance scheme covers deposits of up to SEK 950 000 per person and institution. Depositors can also apply for additional compensation of up to SEK 5 million for deposits related to various life events in the past 12 months, such as the sale of a home.

Depositors need to be made aware of the deposit insurance scheme

It is important that depositors have a sufficient awareness of the deposit insurance scheme. When an institution's ability to pay its debts is called into question for some reason, many depositors might want to withdraw their money all at the same time in what is known as a bank run. Customer deposits are often an important form of funding for banks and other institutions. If too much of this funding suddenly is withdrawn, the institution may, in the worst-case scenario, need to be closed down or placed into resolution. Institutions have a duty to inform their depositors about the deposit insurance scheme at least once a year and when a new account is opened. In a crisis, the Debt Office will communicate actively with depositors to inform them about the scheme.

Precautionary support

Where there is a threat of serious disruption in the financial system, the government may in some cases provide precautionary support, via the Debt Office, to systemically important credit institutions that have run into various types of temporary difficulty but which are fundamentally viable.[5] Support of this kind requires government approval.

The basic rule in the resolution regime is that all forms of public support for banks and other institutions should be limited. The regime therefore defines public support as one of the grounds on

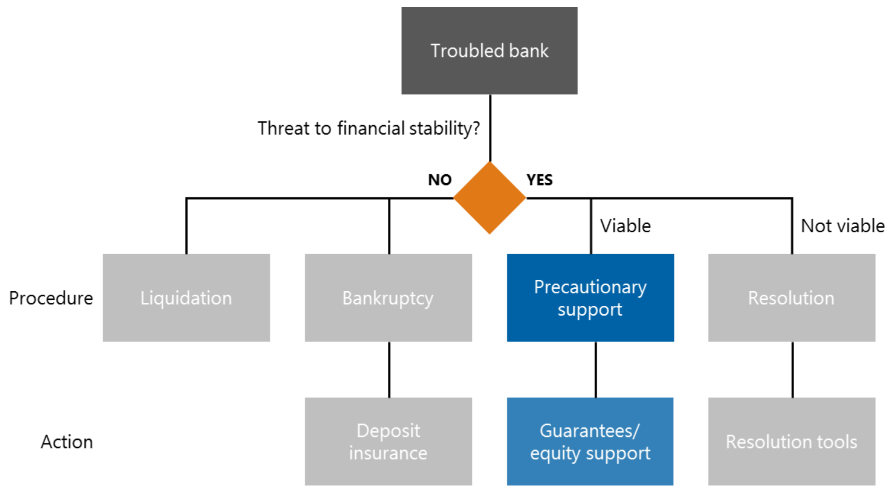
[5] *By law, precautionary support may only be issued to credit institutions, i.e. banking companies, members banks, savings banks and credit market companies.*

which the supervisory authority can conclude that an institution is failing (see also the section *The resolution process – The decision phase*). There are, however, a few possibilities for providing support to viable institutions. This is referred to as precautionary support in Swedish law and may be provided by the Debt Office in three different ways:

- Guarantees for the institution's wholesale funding.
- Guarantees for the Riksbank's loans to the institution.
- Equity support (injecting share capital or buying other equity instruments).

The guarantees aim to make it easier for the institution to source liquidity, while equity support is intended to strengthen the institution's own funds.

Figure 5. Systemically important institution that is viable



Precautionary support may only be provided when the following conditions are met:

- The support is temporary and proportionate to the disruption it is intended to mitigate.
- The support is provided on commercial terms and in a way that does not distort competition with other institutions.
- The terms of the support are such that the government is compensated for the risks it entails for taxpayers.
- The support is compatible with EU state aid rules and approved by the European Commission.

The Debt Office must also have an independent party, such as an accounting firm, perform a valuation of the credit institution before it can receive precautionary support. If the valuation identifies any losses at the institution, these must first be borne by its shareholders.

The scope for providing public support is thus more limited today than it was during the financial crisis in 2008-09. This since there are now specific rules in the EU's Bank Recovery and Resolution

Directive and Sweden's Resolution Act specifying what actions may be taken and which greatly restrict the circumstances in which various types of public support may be used. Also, the EU state aid rules impose further restrictions in areas such as pricing and maturities.

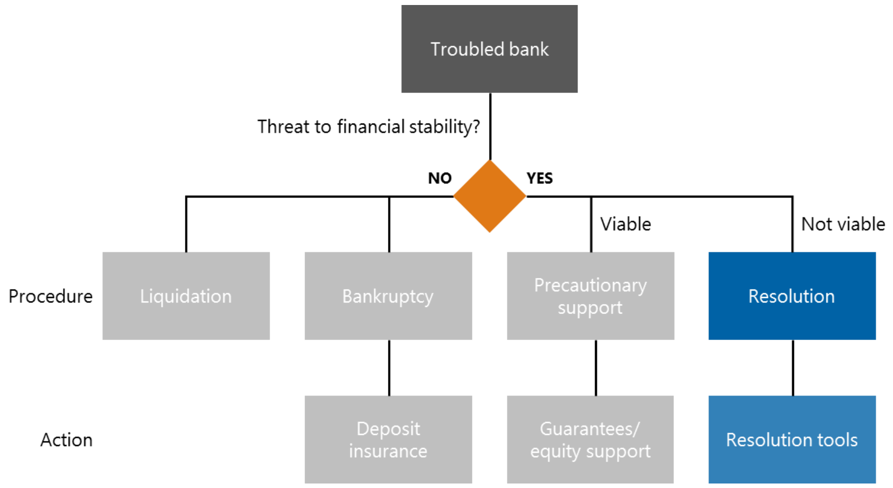
Precautionary support can also be provided to individual institutions only, and eligibility must be tested in each individual case. In several respects, therefore, the support that can now be provided is not be compared with the general measures that were undertaken in Sweden during the global financial crisis.

Resolution

When an institution is placed into resolution, management and control of the institution are transferred to the Debt Office, but the authority does not take over the ownership. The purpose of resolution is to restructure or wind down the failing institution without causing significant disruption to the financial system or its critical functions. If the Debt Office is considering a resolution action that could have direct fiscal or systemic implications, it shall submit the matter to the government for a decision on whether the action can be approved given the risk of such effects.

Resolution means that critical parts of the institution's business can continue without interruption. In practice, the institution will remain open as usual while the resolution procedure is under way. For this to be possible, the Debt Office has a number of tools, strategies and powers to draw on.

Figure 6. Systemically important institution that is not viable



Strategic choices prior to resolution

The decision on how resolution is to be performed is based on two strategic choices: which resolution tool or tools should be used, and, if the institution is part of a group of companies, where in the group the tools should be applied (known as the "point of entry"). Together, these choices make up the main *resolution strategy*. The most appropriate strategy is something the Debt Office evaluates in the planning phase (see the section *Preparing and planning for a crisis*).

Which tool(s) should be used?

The Debt Office has a number of resolution tools at its disposal:

- **The bail-in tool** – To restructure an institution's balance sheet, the Debt Office may write down its liabilities or convert them into new equity. This takes place after shareholders' holdings have been written down. In this way, the own funds can be restored, and the institution made viable again, without taxpayers or anyone else having to inject money from outside.[6] This tool is used to restore an institution's viability.
- **The sale of business tool** – The Debt Office sells all or parts of the business to a buyer, such as another institution.
- **The bridge institution tool** – All or part of the institution placed into resolution is transferred to a "bridge" institution, which is a separate legal entity controlled by the Debt Office. The aim of the bridge institution is to continue to operate the part of the business that is critical during a transition period until it can be sold or wound down.
- **The asset separation tool** – Assets and liabilities not considered critical for the functioning of the financial system can be separated from the institution in resolution and managed via an asset management vehicle (or "bad bank"). The aim here is to wind them down over a longer period of time in order to avoid any unnecessary destruction of value in a situation where market prices may be temporarily depressed.

These tools can be used individually or in combination (except for asset separation, which can only be used together with one of the others).

If these tools are not sufficient to deal with the problems, the government may step in and make a capital injection or temporarily assume ownership of the institution. However, this can happen only if the institution's shareholders and creditors have borne losses corresponding to 8 per cent of the assets, there is a systemic crisis, and the terms of the support are compatible with the EU state aid rules. This tool is known as the *government stabilisation tool* and require a decision from the government.

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[6] *Certain types of liabilities, including secured liabilities and insured deposits, must always be exempted from bail-in. In special cases, other liabilities may also be exempted, for example if writing down a certain type of debt could be expected to threaten financial stability. In this case, losses must either be borne by the institution's other creditors or be covered by an injection from the resolution reserve. The latter option, however, requires a certain percentage of the institution's liabilities (corresponding to 8 per cent of total assets or 20 per cent of risk-weighted assets) already to have been written down. The bail-in tool may also be used to capitalise a bridge institution.*

Where should the tools be applied?
If the failing institution is part of a group of companies, two different approaches may be taken:

- *Single Point of Entry (SPE)* is where the group is dealt with collectively, such that only one of the institutions – generally the parent company – is placed into resolution.
- *Multiple Point of Entry (MPE)* is where one or more institutions within the group are placed into resolution and dealt with separately.

SPE is suitable for groups with a high level of integration and interconnectedness between parent company and subsidiaries, for example when it comes to funding and risk management. MPE may be appropriate if institutions within the group operate relatively independently of one another.

Resolution strategies
Once it is decided which resolution tool(s) should be used and where, the resolution strategy is in place. The most likely strategy for large, complex institutions is known as an "open bank bail-in". This means that the entire institution is kept open during the resolution process while its debt is being written down or converted into new equity using the bail-in tool. The original shareholders will at this point already have had their holdings fully written down. Under this strategy, the institution's business operations remain in the original legal entity.

Resolution can also be based on a transfer strategy, where the sale of business, bridge institution and/or asset separation tools are used to transfer all or parts of the failing institution's business to another party. This type of strategy may be suitable when only parts of the institution's business are considered critical and need to be kept going through the resolution process.[7] A transfer strategy may also be an option when it is not possible to restore the institution's viability within the existing legal entity.

General resolution powers
Besides the tools mentioned above, the Debt Office has a number of general powers that can be used to execute a resolution. For example, the Debt Office can amend the terms of existing debt instruments issued by the institution to extend their maturity, or decide on a temporary moratorium on some of the institution's contractual obligations, such as making payments or deliveries. To ensure the institution's continued funding, loans or guarantees may be issued from the resolution reserve. The Debt Office also has the power to replace the institution's board and CEO.

The resolution process
For a resolution to be carried out effectively, the actions outlined above need to be performed in a certain order (see Figure 7). How long a resolution procedure takes also depends on the specific circumstances and underlying causes. The tools used also affect the amount of time it takes to complete. An outright sale of the institution in resolution will, for example, take less time than a complex bail-in process.

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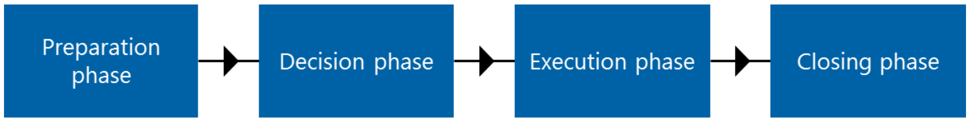
[7] *The asset separation tool may only be used in combination with another resolution tool.*

Figure 7. Process for executing a resolution



The preparation phase

The Debt Office needs to make a number of preparations before a decision on resolution can be taken. Based on the pre-prepared resolution plan, the Debt Office may need to update its assessment of which parts of the institution's business are critical given the actual situation. The Debt Office also needs to ensure that the resolution strategy developed during the planning phase is still the most appropriate one.

Before the Debt Office takes a decision on resolution, an independent party, such as an accounting firm, needs to value the institution's assets and liabilities.[8] This valuation is then used as a basis for the Debt Office's decisions, such as how far different creditors' holdings should be subjected to bail-in. The valuation also serves as a point of reference when subsequently assessing the outcome for shareholders and creditors.

In several parts of the preparation phase, the Debt Office will work closely with Finansinspektionen and the Riksbank. In cases where an institution has activities outside Sweden, the relevant resolution colleges will also be consulted and, where warranted, decisions will be taken together with the relevant foreign resolution authorities (see box *International collaboration and resolution colleges*).

The decision phase

The conditions that must be met for an institution to be placed into resolution are laid down in law. These are:

- The institution must be failing or considered likely to fail.
- There are no alternative measures that could prevent its failure.
- Resolution is necessary in the public interest.

The first condition is tested by Finansinspektionen. The reasons for an institution to fail may be that it has mismanaged its business in a way that warrants withdrawal of its licence, that the value of its liabilities exceeds that of its assets, that it is unable service its debt, or that it is in receipt of government support (other than precautionary support). If Finansinspektionen believes that any of these circumstances apply, the matter is referred to the Debt Office.

[8] *This valuation is separate from, and based on different assumptions to, the valuation normally used by Finansinspektionen to determine whether an institution is failing.*

The Debt Office then tests whether it is in the public interest for the institution to be placed into resolution.[9] Although the public interest criterion might support resolution for reasons other than systemic importance, resolution will generally be used only for systemically important institutions.[10] If the Debt Office believes that resolution is indeed in the public interest, it will consider whether there are any remaining actions that could be taken by Finansinspektionen, the institution or others to prevent the institution from failing. If not, the Debt Office is to place the institution into resolution.

The exact timing of the resolution decision may vary. Where possible, it will be taken in connection with the weekend when financial markets are closed. The Debt Office will communicate what steps have been taken – in other words, that the institution has been placed into resolution and is under the Debt Office's control, which resolution actions have been chosen, and that the board and CEO have been replaced. If the resolution decision is taken at the weekend, this communication will take place before the markets reopen on Monday.

The Debt Office aims to be as transparent as possible and to publish such information which enables market participants to assess the institution's financial position.

In connection with the resolution decision, the Debt Office may also need to take steps to safeguard the institution's continued funding during the first part of the resolution process. Even with a successfully executed bail-in, an institution in resolution may find it difficult to refinance wholesale funding as it matures and to retain deposits, for example due to continued market turmoil. Temporary liquidity support from the resolution reserve or central banks may therefore be crucial for an orderly and successful resolution. The use of the resolution reserve counts as state aid and must therefore be approved by the European Commission.

The execution phase
In this phase, the various decisions that the Debt Office has taken are implemented. This includes various practical measures needed to execute the bail-in and/or transfer, such as swapping debt instruments for shares.

If the bail-in tool has been used, the new board and CEO will be tasked with drawing up a business reorganisation plan. This must include a description of the actions that need to be taken to restore the institution's long-term viability. The new management – in some cases based on directions from the Debt Office – is also responsible for the day-to-day running of the business from the point in time of the resolution decision.

The closing phase
When there is no longer a need for further resolution measures, the Debt Office can draw the process to a close. The Debt Office will declare the resolution complete and hand over

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[9] Resolution is to be considered in the public interest if (1) the action is necessary to achieve one or more of the so-called resolution objectives, (2) the action is proportionate to these objectives, and (3) winding up the institution by means of bankruptcy or liquidation would not meet these objectives to the same extent. The resolution objectives are: (1) to ensure the continuity of critical functions, (2) to avoid significant adverse effects on financial stability, (3) to protect public funds, (4) to protect depositors in accordance with the Deposit Insurance Act (1995:1571) and investors under the Investor Compensation Act (1999:158), and (5) to protect client funds and client assets.

[10] Further arguments concerning the assessment of public interest can be found in Bill 2015/16:5 "Genomförande av krishanteringsdirektivet" [Implementation of the Crisis Management Directive], pp. 359-60.

responsibility to the new owners, board and management. Even once the resolution is completed, however, the Debt Office still has responsibilities and powers to monitor whether the business reorganisation plan is being correctly implemented.

Principles for resolution

Whichever form a resolution procedure takes, there are a number of principles that the Debt Office must always observe in its role as the resolution authority:

- **Shareholders and creditors are to bear all losses.** In previous crises, the solution has often been to inject public funds. With resolution, it is first shareholders and then creditors who must contribute to loss absorption and recapitalisation to the extent necessary to restore the institution's financial position. This applies whichever resolution tool is chosen.
- **Strict rules on when and how public funds may be used.** The main rule is that public funds must not be used for resolution, but there are some exceptions. One condition for such an exception is that shareholders and creditors must first have contributed to loss absorption and recapitalisation equivalent to at least 8 per cent of total assets at the time of the resolution decision.[11]
- **No creditor worse off than in bankruptcy.** The institution's losses are to be distributed in the same order of priority as in bankruptcy. This also means that the outcome of the resolution must be no worse than it would have been had the institution been placed into bankruptcy. If it subsequently emerges that this is the case, shareholders and creditors are entitled to compensation from the resolution reserve.
- **Depositors are always protected.** Depositors' balances up to SEK 950 000 per person and institution are always covered by the deposit insurance scheme, whatever form crisis management takes.

Special decision-making body for financial crisis management

Within the Debt Office, there is a special decision-making body tasked with taking decisions on matters that the Debt Office is required to consider under Sweden's Resolution Act, Precautionary Support Act and Deposit Insurance Act. This body is called the Resolution Board and is to decide on all matters of principle or great importance. In a crisis, this might include decisions on crisis management measures. In the planning process, it decides on minimum requirement for own funds and eligible liabilities (MREL) and resolution plans.

The Resolution Board is chaired by the Director General of the Debt Office and has up to six further members appointed by the government.

[11] *Or, under certain additional circumstances, 20 per cent of risk-weighted assets.*

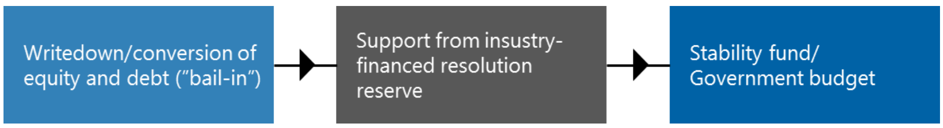
Financing crisis management

The aim of the crisis management framework is that the financial sector should bear the direct costs of financial crises. In the first instance, this means that shareholders and creditors of the troubled institution are to foot the bill. In certain circumstances, however, this may be complemented with external funding. Special arrangements have been established for this purpose, financed by fees paid by the institutions themselves. Common to these arrangements is that they aim to ensure that funds have been set aside in advance for the government to use if financial stability is threatened and an institution's own resources are insufficient. There are three such arrangements in Sweden: the resolution reserve, the deposit insurance fund and the stability fund.

Financing resolution

All institutions are subject to capital requirements. The Debt Office also sets minimum requirement for own funds and eligible liabilities (MREL). Taken together, these requirements aim to ensure that each institution has sufficient capital and liabilities to write down or convert. In this way, the costs are borne by shareholders and creditors. There may, however, be a need for external financing during the resolution phase to cover the institution's ongoing funding needs. A resolution reserve has been created for this purpose. The reserve is being built up with fees paid by the institutions and can provide temporary liquidity in the form of loans or guarantees during resolution.

Figure 8. Resolution financed in the first instance by private stakeholders



In extraordinary circumstances, the resolution reserve may also be used to contribute to the recapitalisation of an institution that has been placed into resolution. However, shareholders and creditors must first have absorbed losses and/or contributed to its recapitalisation equivalent to at least 8 per cent of the institution's total assets at the time of the resolution decision.

The resolution reserve is being built up with fees from the institutions covered by the resolution framework. Resolution fees are to be paid for as long as holdings in the resolution reserve are below 3 per cent of the institutions' total covered deposits. On top of the reserve's holdings, there are credit and guarantee limits set annually by the Swedish parliament.

The resolution reserve consists of an account at the Debt Office (in its Debt Management function). When fees are paid into the account, they form part of the government's general cash flow just like any other payments to the government. When money is needed from the reserve, payment is made from this account, and the government balance sheet is reduced accordingly. This means that incoming fees boost the government's budget balance and decrease its borrowing requirement and the national debt. When payments need to be made, the borrowing requirement and national debt increase.

The resolution reserve is designed in this way to comply with the general principles that apply in Sweden to the government budget and government financing. The idea behind resolution fees reducing the national debt, rather than being ring-fenced in a separate fund, is to contribute to cost-effective management of government finances.

Financing deposit insurance

Deposit insurance means that the deposit insurance scheme bears losses instead of depositors. The deposit insurance scheme itself has considerable protection against losses as a result of the capital and MREL requirements that the authorities set for institutions. In addition, deposits covered by deposit insurance are given priority in the event of bankruptcy, which gives depositors and the deposit insurance scheme additional protection against losses. In this system too, therefore, it is in the first instance shareholders and creditors (other than depositors) who foot the bill. Only then are losses borne by the deposit insurance scheme.

Like the resolution reserve, the deposit insurance fund is financed through fees paid in by the institutions. If the insurance is activated, compensation is paid from the fund. If the fund's capital is not sufficient, there is the option of borrowing from the government. Such loans are to be repaid by charging the institutions additional fees in future years.

All institutions covered by the deposit insurance scheme pay an annual fee to the Debt Office. These fees are transferred to the deposit insurance fund, which is managed by the Legal, Financial and Administrative Services Agency. The fund deposits the fees in an interest-bearing account at the Debt Office or invests them in government bonds. In this way, the deposit insurance fund differs from the resolution reserve and the stability fund.

Financing precautionary support

A special stability fund finances actions taken under the Precautionary Support Act. As can be seen in the section *Precautionary support*, these might be measures to supply liquidity or capital to viable institutions. In cases where the government stabilisation tools are to be used in the context of a resolution, these are also to be financed through the stability fund.

The stability fund was set up in connection with the financial crisis in 2008 to finance support measures for the financial system based on the Swedish legislation of the time. Institutions paid annual fees to the fund until 2016, when the stability fee was replaced with the resolution fee. Part of the stability fund's balance was then also transferred to the resolution reserve. The remaining balance can be used for the purposes stated above. On top of the remaining balance, credit and guarantee limits are set annually by the Swedish parliament. Like the resolution reserve, the stability fund takes the form of an account at the Debt Office.

Preparing and planning for a crisis

Effective crisis management requires extensive planning and preparation. The Debt Office carries out crisis planning for all banks and other institutions, whether or not they are systemically important. Important parts of this work include drawing up plans for how the institutions are to be dealt with in a crisis, and deciding on the minimum requirement for own funds and eligible liabilities (MREL). The aim of MREL is to ensure that there are sufficient liabilities that can be written down and, where necessary, converted into equity if an institution runs into trouble. The Debt Office liaises closely with other national and international authorities and bodies in this preparatory work.

Crisis planning for all institutions

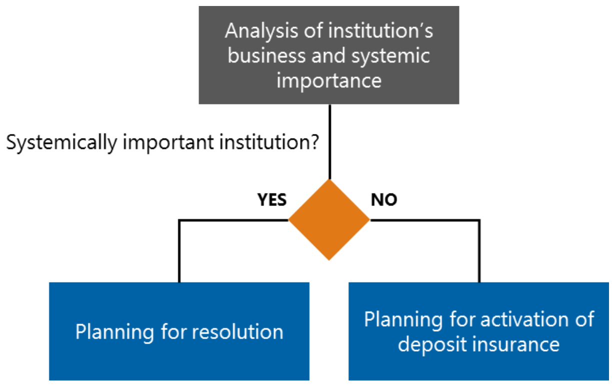
The starting point for the Debt Office's responsibility for resolution and deposit insurance is to ensure that troubled banks and other institutions can be handled without causing serious disruption to the economy and while maintaining good protection for depositors. For this to be possible, the Debt Office carries out extensive planning work.

The Debt Office undertakes crisis management planning for each individual institution. The analysis and assessments performed for each institution are gathered together in a *resolution plan*. This plan sets out how the Debt Office intends to deal with the institution if it fails, and how any obstacles are to be overcome.

Systemic importance determines scope of planning

How extensive this planning needs to be depends on whether or not the institution is considered systemically important (see Figure 9). The general rule is that systemically important institutions are to be placed into resolution, while non-systemically important institutions are to be wound up by means of bankruptcy or liquidation should they fail. The planning for an institution that is systemically important is much more extensive than for one which is not.

Figure 9. Crisis planning for all institutions

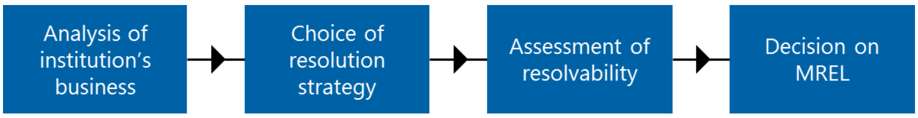


Crisis planning for non-systemically important institutions focuses on ensuring that covered deposits can be paid out quickly and efficiently. For this to be possible, the Debt Office must have correct information about depositors and their deposits as soon as the institution is placed into bankruptcy. The Debt Office therefore carries out regular checks to ensure that institutions are able to provide the necessary information.

Components of resolution planning

The following presents the key components of the Debt Office's annual planning process for systemically important institutions.

Figure 10. Key components of resolution planning



Analysis of the institution's business

The Debt Office's resolution planning is based on the business that the institution conducts. This means identifying whether the institution provides functions that can be considered critical for the functioning of the financial system, and whether allowing the institution to fail might cause the crisis to spread to other parts of the financial system.

Critical functions are services that, if the institution stopped providing them, would probably lead to serious disruption in the financial system. Accepting deposits from the public and issuing mortgages are examples of functions that might be considered critical. Others might be lending to businesses or managing their deposits. For a function to be considered critical, it needs to account for a certain share of the overall market.

When assessing whether allowing an institution to fail might cause the crisis to spread to other parts of the financial system, the Debt Office considers what effect its bankruptcy or liquidation would have on other institutions' ability to provide critical functions. There might, for example, be potential contagion effects in financial markets due to concern among investors.

A general review of the institution's legal structure, organisation, support functions and business model is also performed. Understanding of these aspects is important for the Debt Office to be able to perform a resolution.

Choice of resolution strategy

Resolution strategy is a matter of making various choices about which tools are most appropriate and, where relevant, at what level of a group of companies these tools should be applied if the institution fails (see the section *The Debt Office's responsibilities in the event of a crisis*). This analysis is carried out in advance as part of resolution planning. The Debt Office will choose the strategy which best suits the institution's business operations and its legal and operational structure.

Assessment of resolvability

To ensure that the actions in the plans can be carried out, the Debt Office makes an assessment of systemically important institutions' *resolvability*. If an institution is resolvable, this means that it can be dealt with in accordance with the strategy and without serious disruption in the financial system. The assessment of an institution's resolvability can be divided into financial and operational resolvability. The minimum requirement for own funds and eligible liabilities (MREL) is an important part of ensuring financial resolvability. Aspects of operational resolvability include the institution having agreements in place with its suppliers to ensure that support functions such as IT systems will continue to function during resolution.

Resolvability is tested regularly. If there are significant *impediments to resolvability*, the Debt Office may require the institution to take action to reduce or remove them. If the Debt Office concludes that the actions proposed by the institution do not reduce or remove these impediments, the Debt Office will decide on what actions the institution is to take. This might mean restricting risks, selling assets or making legal changes.

Minimum requirement for own funds and eligible liabilities (MREL)

For resolution to be possible, an institution must have a certain amount of own funds and liabilities that can be written down to cover losses and restore its capital in a crisis. A special requirement has therefore been introduced, known as the *minimum requirement for own funds and eligible liabilities (MREL)*.[12]

MREL is to reflect both loss absorption and recapitalisation needs

It has long been a requirement for banks and other institutions to have sufficient capital to bear unforeseen losses in the event of financial distress (capital requirements). MREL is a complementary requirement which means that an institution must have not only loss-absorbing capital but also sufficient additional capital or debt instruments for it to be *recapitalised* if necessary. This means that the own funds of the institution in resolution is built up again in order to ensure continued operation of the parts of its business that are to survive. This restoration involves applying the bail-in tool, whereby all or part of the institution's liabilities is written down or converted into shares.

For systemically important institutions, MREL is to reflect the expected loss absorption and recapitalisation needs of each individual institution should it fail. The requirement therefore has two components:

- A *loss absorption amount (LAA)*, which roughly corresponds to the institution's capital requirement.
- A *recapitalisation amount (RCA)*, which is to correspond to the amount required to restore its capital to the required levels that will apply to the institution after resolution.

The Debt Office sets an individual MREL for each institution. For institutions that are not considered systemically important, it does not entail any additional need for requirement, because MREL will not exceed the institution's capital requirement.

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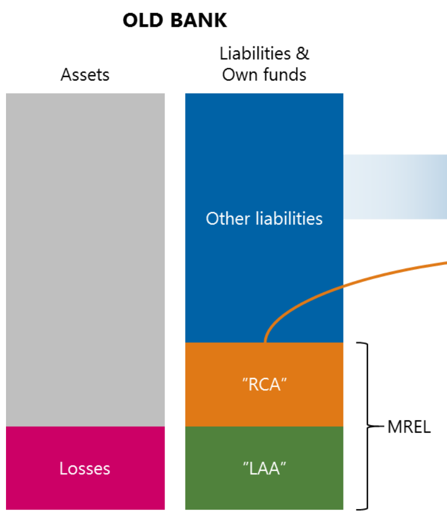
[12] *See the Debt Office's memorandum "Application of the Minimum Requirement for Own Funds and Eligible Liabilities" (RG 2016/425) of 23 February 2017.*

Illustration of how MREL works in practice

Figure 11 presents a schematic description of the bail-in process at an institution where the *whole* of its business is restructured and kept going. In this example, losses arise in the "Old bank" corresponding to the whole of the LAA, which means that the bank's own funds are completely wiped out and the bank is failing. Because the bank is considered systemically important, it is placed into resolution. The Debt Office then converts liabilities into shares to restore the institution's own funds. The amount converted in this example corresponds to the RCA, which, after conversion, makes up the equity of the "New bank".

Figure 11. Example of how MREL works in practice



The liabilities proportion and subordinated liabilities principles

One condition for the Debt Office to be able to perform a bail-in is that the institution's MREL is met with financial instruments that can be written down or converted into equity without causing serious disruption in the financial system. The rules include various fundamental characteristics that instruments must have if they are to count towards MREL. The Debt Office has chosen to complement these rules with two principles on which *additional characteristics* these liabilities must have:

- **Liabilities proportion:** MREL must be met with a certain proportion of debt instruments, corresponding to the recapitalisation amount. This ensures that there are sufficient liabilities that can be written down and, where necessary, converted into equity if an institution fails.
- **Subordinated liabilities:** MREL is to be met entirely with subordinated instruments. Subordinated liabilities are written down before other liabilities, such as deposits from large companies and senior bank bonds. This makes it clear that it is investors in subordinated instruments who, after shareholders, are to bear the costs when an institution fails.

If an institution does not comply with these principles, the Debt Office may take action against the institution to remove these impediments to resolvability (see the section *Assessment of resolvability*).

International collaboration and resolution colleges

The Debt Office collaborates on financial stability in a variety of international contexts. At the heart of this work are the resolution colleges. The Debt Office also participates in a number of international organisations and groups working in various ways to promote crisis management.

Resolution colleges for institutions with cross-border activities

Where an institution has operations in more than one country, all aspects of crisis planning and crisis management need to be co-ordinated between the countries concerned. This co-ordination takes place in what are known as resolution colleges, which consist of representatives of the resolution authorities, supervisory authorities, central banks, deposit guarantee schemes and finance ministries in the countries where the group has subsidiaries or significant branches. The European Banking Authority (EBA) is also invited to participate. The college is led by the resolution authority in the country where the parent entity is domiciled.

Resolution colleges provide a forum for the exchange of information and for decision-making. Members jointly develop group resolution plans, set MREL, assess resolvability and decide on any action to be taken to enable resolution of the group as a whole. In a crisis, the college's role is to agree on what resolution actions are to be taken.

Decisions in the college are taken jointly by its voting members.[13] In the event of disagreement, the matter may be referred to the EBA for binding mediation. The EBA then takes a binding decision that the individual countries must observe. This option generally applies only during the planning phase, however.

Where a group's parent company is registered in Sweden, the Debt Office is responsible for preparing draft resolution plans and leading the work of the colleges. The Debt Office is also a member of the colleges for foreign institutions that have subsidiaries or branches in Sweden.

Other international collaboration to promote financial stability

The Debt Office participates in the international regulatory process in relation to resolution at both European and global level. The Debt Office is Sweden's representative on the Financial Stability Board (FSB) Resolution Steering Group and a member of the EBA's Resolution Committee and associated subgroups.

The Debt Office also collaborates with international representatives of deposit insurance schemes, for example through its membership of the European Forum of Deposit Insurers (EFDI) and the International Association of Deposit Insurers (IADI).

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[13] *Decisions are taken by the group-level resolution authority and the resolution authorities in the countries where the institution has subsidiaries. Other members are entitled only to participate in the work of the college.*

The Swedish National Debt Office is the central government financial manager and the national resolution and deposit insurance authority. The Debt Office thus plays an important role in the Swedish economy as well as in the financial market.

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