Japan's Orderly Resolution Regime for Financial Firms
-A New Scheme Provided for Under the Revised DIA-

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I. Providing for a new resolution regime

On 12 June 2013, the 183rd session of the Diet passed legislation to partially amend the Financial Instruments and Exchange Act, enacting the new law on 19 June. The changes tighten insider-trading regulations in response to insider trading related to public offerings, revise rules on asset management in response to the AIJ scandal, revise the 5% rule on banks' voting rights as well as rules on large credit exposure, and diversify the funding methods and capital structure policies of investment companies. The changes also provide a new framework for resolving financial institutions by adding to the Deposit Insurance Act (DIA) measures for the orderly resolution of financial firm assets and liabilities that try to stabilize the financial system.

The widespread financial panic experienced during the global financial crisis, particularly in the aftermath of the failure of Lehman Brothers, made it widely known globally that there was no framework for achieving the cross-border resolution of systemically important financial institutions (SIFIs) that avoided market turmoil. This experience reaffirmed the need for countries to cooperate under the auspices of the G20 in building a framework of orderly resolution, and motivated an international dialogue aimed at building such a framework.

Consequently, the Financial Stability Board (FSB) proposed new global standards for the resolution of financial institutions in its report, "Key Attributes of Effective Resolution Regimes for Financial Institutions," and the "Key Attributes" were approved by the G20 leaders at the Cannes Summit in November 2011[1]. The FSB's Key Attributes defines the tools and powers that each country must have at its disposal, with the express aim of achieving the global convergence of resolution regimes. The FSB began working toward such convergence in August 2012 with an initial peer review of each G20 country's resolution regime using the Key Attributes as a benchmark[2].

1 See FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions," October 2011 (*available at* http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

2 FSB, "Thematic Peer Review of Resolution Regimes," Questionnaire, 3 August 2012 (*available at* http://www.financialstabilityboard.org/publications/r_120813.pdf).

Meanwhile in Japan, reflecting the lessons learned from its financial crisis and the global trend in financial supervision and regulation, a working group was established within the Financial System Council in May 2012 to consider the measures needed to stabilize the financial system, officially named the Working Group on Method of Regulations on Banks which Contribute to Stability of the Financial System, etc. (the Banking Regulation Working Group, or BRWG). The BRWG initially debated modifying the 5% rule and restrictions on large credit exposure, but beginning in August 2012 it also began debating a framework for resolving financial firms.

When the Financial System Council started discussing frameworks for orderly resolution, the Key Attributes had already been approved by the G20 countries at the Cannes Summit, and the US, the UK, and the eurozone countries were already making headway in improving their resolution regimes[3]. Additionally, the Article IV Consultation report released by the IMF in August 2012 and also its Financial Sector Assessment Program (FSAP) included recommendations that Japan implement a resolution framework[4].

The BRWG released a report in January 2013 summarizing the results of its meetings[5]. That report argues that because the failure of SIFIs that occurred during the global financial crisis triggered by the failure of Lehman Brothers became a market-spread contagion that seriously affected the real economy, a framework for the orderly resolution of financial firms needs to be created to prevent such contagion. It was with this understanding that the BRWG report proposes a new framework for the orderly resolution of financial institutions.

Specifically, as a framework that can be applied to the entire financial industry, including banks, insurance companies, securities firms, and bank holding companies, it is a resolution scheme aimed at ensuring the execution of systemically important market transactions by way of a resolution by the Council for Financial Crises, chaired by the Prime Minister, and under the oversight of the Deposit Insurance Corporation of Japan (DICJ), with the DICJ providing liquidity, and if necessary recapitalization and funding assistance. The previous resolution regime provided under the DIA was aimed at dealing with traditional systemic risk, namely a run on deposits, a freezing of bank credit in the interbank market, and a chain of payment

3 The Dodd-Frank Act passed into law by the US in July 2010 contained the Orderly Liquidation Authority, which are rules on resolution regime for nonbank financial institutions, including bank holding companies, broker-dealers, and insurance companies. In addition, the UK established a special resolution regime for banks under its Banking Act 2009. In the EU, the European Commission proposed in June 2012 an EU directive aimed at providing an EU-level mechanism for coordinating resolution regimes for banks and investment banks.

4 The IMF is obligated, under Article IV of the IMF's Articles of Agreement, to provide oversight of IMF member nations' economic policies and financial systems and to make policy recommendations as appropriate, with a view toward maintaining the stability of the international currency regime and preventing crises (Article IV Consultations). Additionally, the FSAP, an IMF program to assess the soundness of each country's financial system, was incorporated within the Article IV Consultation framework.

5 See Working Group on Framework of Regulations on Banks which Contribute to Stability of the Financial System, etc., "Review of Regulations on Banks which Contribute to Stability of the Financial System, etc.," 25 January 2013 (*available at* http://www.fsa.go.jp/en/refer/councils/singie_kinyu/reports/20130128/03.pdf).

failures in the settlement system, while the new resolution scheme is aimed at dealing with market-based systemic risks that arise from the drying up of market validity and the destabilization, failure, or reduced functioning of markets.

The FSA drafted a revised DIA in accordance with the BRWG's deliberations, including it within draft legislation to partially amend the Financial Instruments and Exchange Act that it submitted to the Diet in April 2013, an amendment that was recently passed into law[6]. We summarize below the current resolution regime as it relates to the FSB's Key Attributes, and then provide an overview of the new resolution scheme with reference to the BRWG report.

II. The current resolution framework and the Key Attributes

1. The current framework for resolving financial institutions

Under the DIA, when a deposit-taking institution (bank) fails, the law stipulates that (1) the entire principal of "payment and settlement" deposits, which include demand deposits and non-interest-bearing savings accounts, be protected and (2) regular deposits, including regular savings accounts (interest-bearing) and time deposits, be protected up to a principal of ¥10 million per depositor plus the interest on that principal. The DIA not only defines this scheme for deposit insurance, it also provides a framework for resolving banks.

The resolution framework within the DIA provides for a financial administrator, which includes the DICJ, to handle the resolution process for the failed bank[7]. This resolution scheme provided for by the DIA includes two approaches: (1) the payment of insurance proceeds to depositors and the liquidation of the failed bank, known as the "insurance payoff" approach and (2) the transfer of the insured deposits and corresponding assets to a private-sector acquiring bank, at which point funding assistance can be provided up to an amount equivalent to the cost of paying the insurance proceeds (payoff cost), known as either the "financial assistance approach" or the "purchase and assumption" approach[8]. Furthermore, (3) if an acquiring bank cannot be immediately identified, the DICJ can temporarily transfer its loan assets and deposits to a bridge bank in which it has invested capital, and the DICJ will operate this bridge bank until it is ultimately replaced by an acquiring bank.

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6 The revised DIA will go into effect on the date specified by administrative order, which must be no later than nine months after its date of promulgation.

7 Rules on the use of financial administrators (receivers) were introduced with the revision of the DIA in 2000. In addition to the DICJ, financial administrators are expected to be selected from among attorneys, CPAs, and practitioners in the financial sector.

8 The cost of paying the insurance in the event that the insurance payoff approach is used is the total of the insurance benefits expected to be paid plus the costs expected to be incurred in making those payments, less the amount expected to be recovered through bankruptcy proceedings from the deposits/claims acquired by the DICJ, in accordance with the insurance benefits paid. Included under the funding assistance approach are (1) monetary grants, (2) loans and deposit-taking, (3) the outright purchase of assets, (4) the guarantee of debt, (5) the assumption of debt, (6) the underwriting of preferred stock, and (7) security for damages.

In an attempt to deal with the financial system instability brought by the overhang of nonperforming loans (NPLs) in the 1990s, Japan eliminated its deposit insurance cap in 1996, thus providing insurance on all deposits, but later reintroduced the cap, first on all deposits other than regular savings in April 2002, and then on regular savings accounts as well in April 2005. Under current rules, the credit claims of a failed bank's creditors, including holders of uninsured deposits, get reduced when a bank becomes insolvent. The resolution of the Incubator Bank of Japan in September 2010 marked the first time since Japan introduced deposit insurance in 1971 that depositors with funds exceeding the insurance cap did not recover the entire amount of their deposit[9].

Under the DIA, exceptional measures known as the systemic risk exception apply when there is danger of a financial crisis. Specifically, if the Prime Minister deems that not taking crisis measures would create a risk of material impediments to maintaining credit system stability in Japan or regions where the affected bank operate, such measures can be taken following deliberations of the Council for Financial Crises. The financial crisis measures spelled out in Article 102-1 of the DIA came under three different categories.

✧ If the subject bank is not insolvent:

Measures under item 1:	Recapitalization with public funds: the underwriting of stock by the DICJ

✧ If the subject bank is insolvent:

Measures under item 2:	Financial assistance for amounts in excess of insured amounts: insurance for full amount of deposits
Measures under item 3:	Special crisis management (temporary nationalization): acquisition of the subject bank's stock by the DICJ

In principle, the DIA protects insured bank deposits while pursuing resolution procedures that allow for reductions of uninsured deposits and general credit claims, but it has a mechanism that allows for special measures to avoid a financial crisis, including recapitalization with public funds, the protection of all deposits, and temporary nationalization. Following the failures in November 1997 of Sanyo Securities, Hokkaido Takushoku Bank, and Yamaichi Securities, and then the experience of dealing with a crisis brought by the failure of Long-Term Credit Bank and Nippon Credit Bank in late 1998, financial crisis measures were incorporated into the DIA with a revision in 2000[10].

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9 The first reimbursement rate on uninsured deposits at the Incubator Bank of Japan was 39% (*available at* http://www.dic.go.jp/english/e_shinko/e_seisan/e_seisan1.html)

10 Measures to deal with a financial crisis under Article 102 of the DIA were introduced after taking into account recapitalization with government funds under the Act on Emergency Measures for Early Strengthening of Financial Functions (Early Strengthening Act) that began in March 1999 as well as the special public administration of the Long-Term Credit Bank and Nippon Credit Bank in 1998 under the Act on Emergency Measures for the Revitalization of the Financial Functions (Financial Revitalization Act).

These financial crisis measures have already been used. In May 2003, Resona Bank received an injection of public capital (item 1 measures), and in October 2003 Ashikaga Bank was put under special public administration (item 3 measures), thereby preventing a financial crisis from developing.

For the resolution of securities firms, life insurers, and other nonbank financial institutions, there is the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions (Special Corporate Reorganization Act), which covers banks as well as securities firms and insurance companies and is meant to simplify and speed up procedures for bankruptcy, reorganization, and rehabilitation[11]. Prior to this Act becoming law, there was no mechanism for resolving the failure of nonbanks that also avoided market disruptions. In this regard, the IMF's Article IV Consultation report and FSAP country report requested that Japan create a mechanism for the orderly resolution of systemically important nonbank financial institutions.

Additionally, large banking groups led by a bank holding company follow a financial conglomerate business model, but the DIA only provides procedures to resolve the failure of these groups' bank subsidiaries, and does not cover the bank holding company or other group subsidiaries. Of the financial crisis measures, recapitalization with public funds allows for the DICJ to underwrite stock in a bank holding company, but the use of those funds is limited to recapitalizing the bank subsidiary and the bank holding company must recapitalize its bank subsidiary with at least an equivalent amount of its own funds, making it impossible to use public capital for group subsidiaries other than the bank subsidiary[12].

Japan built fairly solid mechanisms for dealing with financial crises after experiencing its financial crises starting in the 1990s, but those mechanisms do not provide a way to achieve orderly resolution while avoiding market disruption for nonbank financial institutions, and they are also lacking a mechanism for resolving

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11 The Special Corporate Reorganization Act aims to facilitate the bankruptcy process for financial institutions undergoing bankruptcy, reorganization, or rehabilitation procedures while also protecting the rights of depositors, investors, and the insured. For example, in the case of a bank, the DICJ creates a table of depositors and represents them during the bank's bankruptcy proceedings; if a securities firm, the Japan Investor Protection Fund creates a table of clients and represents them; and if an insurance company, the Life Insurance Policyholders Protection Corporation of Japan creates a table of policyholders and represents them. The bankruptcies that have been resolved under the Special Treatment Act include Chiyoda Mutual Life Insurance and Kyoei Life Insurance in October 2000, Tokyo Mutual Life Insurance in March 2001, and Daiwa Life Insurance in October 2008.

12 In the 2000 revision of the DIA, which introduced financial crisis measures, recapitalization using public funds was not authorized for bank holding companies. This limits the ways in which the public can recover its investment, however, because recapitalizing the bank subsidiary severs the equity relationship between the bank holding company and the bank subsidiary, and the shares acquired by the government becomes unlisted shares. Because of this, the 2004 revision allowed the injection of public funds into bank holding companies, and to prevent bank holding companies from using the public funds for purposes other than recapitalizing their bank subsidiaries, required them to use an equivalent amount of their own capital to recapitalize the bank subsidiary (see document 3-2-1 of Kin'yuuchou no Ichinen (FSA's year in review), FY2004 (in Japanese)).

the failureof entire financial groups. We think there is room to improve Japan's current resolution regime and make it more robust to systemic risk.

2. Requirements of the Key Attributes

Meanwhile, FSB's Key Attributes, which have been proposed as "a new international standard for resolution regimes," establishes a number of requirements for resolution regimes with a view toward achieving their global convergence.

First, the purpose of an orderly resolution regime under the Key Attributes is to (1) avoid severe systemic disruptions, (2) avoid taxpayer exposure to loss, and (3) protect vital economic functions through mechanisms that make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation. The reason why avoiding taxpayer exposure is part of the Key Attributes is that large amounts of public funds had to be invested in the financial sector during the financial crisis, particularly in Europe and the US, and this was one reason for the worsening of budget deficits and the sovereign debt crisis. To avoid taxpayer exposure, the Key Attributes call in principle for the shareholders and creditors of failed financial institutions to bear the losses incurred with resolution.

Next, the Key Attributes stipulate that all types of systemically important financial institutions (SIFIs) should be covered by the regime, including non-bank financial institutions. In particular, they argue that coverage must be extended to (1) holding companies, (2) non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate, and (3) branches of foreign financial institutions.

The Key Attributes also stipulate that a condition for beginning orderly resolution should be that the firm be no longer viable and have no reasonable prospect of becoming so. Additionally, the Key Attributes stipulates the resolution powers that the resolution authority should have, as necessary. These include:

(1) To remove and replace the senior management and directors, and to appoint an administrator of the failed financial institution

(2) To operate and resolve the failed financial institution, including powers to terminate contracts, purchase or sell assets, write down debt

(3) To establish a temporary bridge institution and initiate a bail-in (including by writing down or converting to equity the unsecured debt

Under the current DIA, the financial administrator appointed by the Prime Minister can appoint senior management and manage and dispose of the property of the failed bank, while maintaining the right of representing the failed bank, performing its services, and managing and disposing of its property. Additionally, the DIA provides for a resolution scheme via a bridge bank. For insurance companies, the Insurance Business Act provides a mechanism for an insurance administrator with the same rights as a financial administrator, and there is a regime for bridge insurance companies to take over the insurance policies of the failed insurer. On the other hand, there are no special measures in place for securities brokers/dealers or other types of nonbank financial institutions.

Meanwhile, bail-ins have been looked at closely as a tool for the orderly resolution of SIFIs since the financial crisis. In contrast with the bail-out of the financial institution using public funds, a bail-in is a tool to resolve bankruptcies that avoids taxpayer exposure to loss by focusing losses on shareholders and creditors through the write-down of equity or unsecured and uninsured creditor claims or conversion to equity of unsecured and uninsured creditor claims on the failed financial institution. The Key Attributes define the following bail-in powers as necessary for the resolution authority.

(1) The power to write down in a manner that respects the hierarchy of claims in liquidation equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses

(2) The power to convert into equity or other instruments of ownership of the firm under resolution (or any successor in resolution or the parent company within the same jurisdiction), all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation

(3) The power to convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution and treat the resulting instruments in line with (1) or (2)

Additionally, agreements for derivatives and other financial transactions normally include early termination rights triggered by the start of resolution procedures[13]. When a financial institution fails and its numerous counterparties rush to achieve early termination in order to protect their own transactions, there is a possibility that this disorderly termination of agreements will cause further market turmoil, making orderly resolution impossible. With this in mind, the Key Attributes argue that the resolution authority must have the power to temporarily stay (for a period not exceeding 2 business days, for example) the early termination rights in derivative contracts.

To cover resolution costs, the Key Attributes require that (1) to cover the cost of providing temporary funds to achieve orderly resolution, jurisdictions should have in place privately-financed deposit insurance or resolution funds, or a funding mechanism for ex post recovery from the industry and (2) the authority must only be allowed to supply temporary funds under strict conditions in order to prevent moral hazard. The focus is on preventing the moral hazard created by “too big to fail” and on avoiding taxpayer exposure.

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[13] Under the ISDA Master Agreement, in normal circumstances it is possible to give prior notice and terminate an agreement, then use netting for settlement, but in the event of default it is possible to choose a rider that automatically terminates the agreement early.

Specifically, the Key Attributes asks that each country create a resolution regime that does not rely on public solvency support and does not create the expectation that such support will be available, and provide a legal framework so that authorities are not constrained to rely on public ownership or bail-out funds as a means of resolving financial institutions. It notes, however, that as a last resort and for the overarching purpose of maintaining financial stability, some countries may decide to have a power to place the financial institution under temporary public ownership and control in order to continue critical operations, while seeking to arrange a permanent solution such as a sale or merger with a private-sector entity. The Key Attributes therefore tolerate the possibility of public control over a failed financial institution under some conditions.

Under the current DIA, the costs of limited protection are covered by a deposit insurance fee assessed on deposit-taking institutions ex ante, and if measures to deal with a financial crisis wind up being deployed, the required costs are collected from financial institutions ex post. Furthermore, it is possible for the government to provide assistance if there is a risk that this ex post levy on financial institutions will worsen their financial position and destabilize the credit system. A special feature of Japan's resolution regime is that while it tries to avoid the moral hazard from too-big-to-fail, it allows for a final backstop from the government to cover the costs of resolution.

III. A new resolution regime added to the DIA

The revised Deposit Insurance Act adds a new resolution regime to the existing mechanisms within the current DIA, namely the resolution regime related to limited protection and the financial crisis measures outlined in Article 102, by specifying measures for the orderly resolution of the assets and liabilities of financial institutions that attempt to stabilize the financial system. The BRWG report proposes a new resolution scheme that provides a safety net for financial markets and for the entire financial industry with a view toward protecting the resilience of the financial system and avoiding a sharp decline of confidence in financial markets, turmoil related to bankruptcies, and impacts on the real economy. This new resolution scheme would therefore also cover nonbank financial institutions that are not covered by the current law and aim to protect against "market-based" systemic risk that is propagated globally via markets, a fundamentally different objective than the existing mechanisms to deal with bank-based crises.

1. The financial firms covered by the scheme

The mechanism for the orderly resolution of the assets and liabilities of financial institutions described in the BRWG report covers the entire financial sector (including deposit taking institutions, insurance companies, financial instruments business operators (FIBOs) such as securities companies and asset management companies, and financial holding companies), and the revised DIA based on that report defines financial firms as not only banks but also bank holding companies and any subsidiaries of banks and bank holding companies, and thus the mechanism applies to entire bank holding company groups (Article 126-2(2))[14]. Insurance companies, insurance holding companies, and their subsidiaries are also defined as financial firms, as are securities firms (those Type 1 FIBOs involved in the securities business), designated parent companies (those designated parent companies of Type 1 FIBOs with assets of at least ¥1 trillion), and their subsidiaries[15]. In other words, insurance companies and certain securities firms are also subject to an orderly resolution scheme at the group level[16].

2. Requirements for triggering measures

The new resolution regime is triggered when the Prime Minister deems that not doing so would risk extreme turmoil in Japan's financial markets and other aspects of its financial system, and he confirms them as necessary (Special Confirmation) following deliberation of the Council for Financial Crises (Article 126-2(1)). There are two distinct resolution schemes in the event of Special Confirmation. Item 1 special measures are used for those financial firms that do not meet the conditions of being insolvent, being at risk of becoming insolvent, having stopped payments, or being at risk of stopping payments. Item 2 special measures are used for financial institutions that do meet the above conditions.

3. Overview of resolution schemes

1) When not meeting the insolvency and other conditions (Item 1 special measures)

When Item 1 special measures are applied to a financial firm that does not meet the insolvency conditions, that firm is placed under special oversight by the DICJ (Article 126-2(1)(1)). Financial firms in this status must submit to oversight by the DICJ of their performance of the business and their management/disposal of assets[17].

Under Item 1 special measures, the DICJ can, in order to avoid the risk of extreme turmoil in Japan's financial system, provide the affected financial firm with liquidity

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14 Based on the requirements of the Key Attributes, branches of foreign banks are also included in the definition of financial institutions.

15 The Daiwa Securities Group and Nomura Holdings are designated parent companies (see FSA, List of designated parent companies, as of 22 April 2011).

16 Additionally, securities financing corporations and other entities designated by ordinance as having an important position within Japan's financial system are also included in the definition of financial firms. Legally, subsidiaries other than the securities holding company and securities subsidiaries within a securities holding company group that is not a designated parent company are not included in the definition of financial firms. The specific government directives must be checked to determine the treatment of securities holding company groups, FIBOs other than securities companies, and other nonbank financial institutions.

17 Special oversight lasts for a one-year period as a rule, but can be extended up to another year if circumstances make it impossible to end.

and debt guarantees based on a resolution by its Steering Committee (Article 126-19(1))[18]. The BRWG report, on the assumption that the financial institution is not insolvent, argues the need to take measures that attempt to stabilize the market by supplying deposit-taking institutions with liquidity and enabling them to discharge all liabilities as agreed, while trying to reduce and eliminate market transactions. Item 1 special measures aim to avoid a systemic crisis by supplying the financial firm with liquidity, and comprise an open bank resolution scheme that seeks resolution in parallel with keeping the financial firm a viable concern.

They also allow the DICJ to underwrite certain types of financial instruments (including preferred stock, subordinated bonds, subordinated loans, and stock other than preferred stock), while recapitalization with public funds is a measure put in place to enhance the financial firm's capital and otherwise improving its financial position (Article 126-22(1))[19]. The BRWG report argues that measures are needed that enable the DICJ to underwrite preferred shares, sell assets, and/or transfer businesses in preparation for the end of oversight. In other words, the measures in Article 102(1)(1) of the DIA allow for recapitalization using public funds from the very beginning, but under Item 1 special measures, recapitalization is done when necessary with the firm in the process of looking for an exit from oversight by the DICJ and already in the process of restructuring, either on its own or with the help of a third-party investor (Figure 1). If preferred shares are underwritten, a business improvement plan is required[20].

2) When meeting the insolvency conditions (Item 2 special measures)

When Item 2 special measures are applied to insolvent financial firms, just as with Item 1 special measures, the firm is placed under special oversight by the DICJ (Article 126-2(1)(2)). Additionally, when the Prime Minister deems that (1) the financial firm has been operating its business in a starkly inappropriate manner or (2) there is a risk of extreme turmoil in Japan's financial system if the financial firm ceases operating all of its businesses or dissolves its debts, special oversight will be halted, and the DICJ will put the firm's business and assets under special administration (disposition ordering special administration)[21]. In the event of such disposition order, the DICJ has the right to represent the financial firm, perform its duties, and manage and dispose of its assets. Under special administration, the DICJ has the same powers as a financial administrator and is responsible for resolution procedures.

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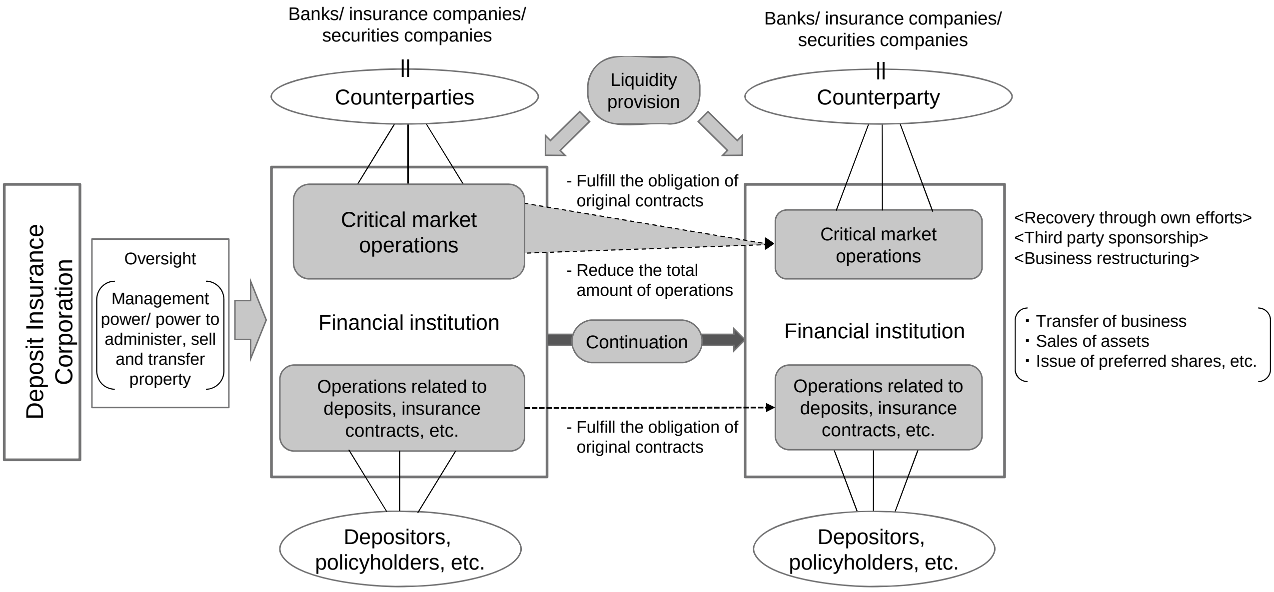
18 Loans and loan guarantees provided by the DICJ rank behind general liens under the Civil Code and ahead of other credit claims in priority to receive payment and are defined as rights to receive payment from the exercise of reimbursement rights, placing them higher than general credit claims in the credit hierarchy.

19 In the case of an insurance company organized as a mutual, it is also possible to raise funds.

20 Business improvement plans are required to include measures to streamline the business and establish a management structure with accountability.

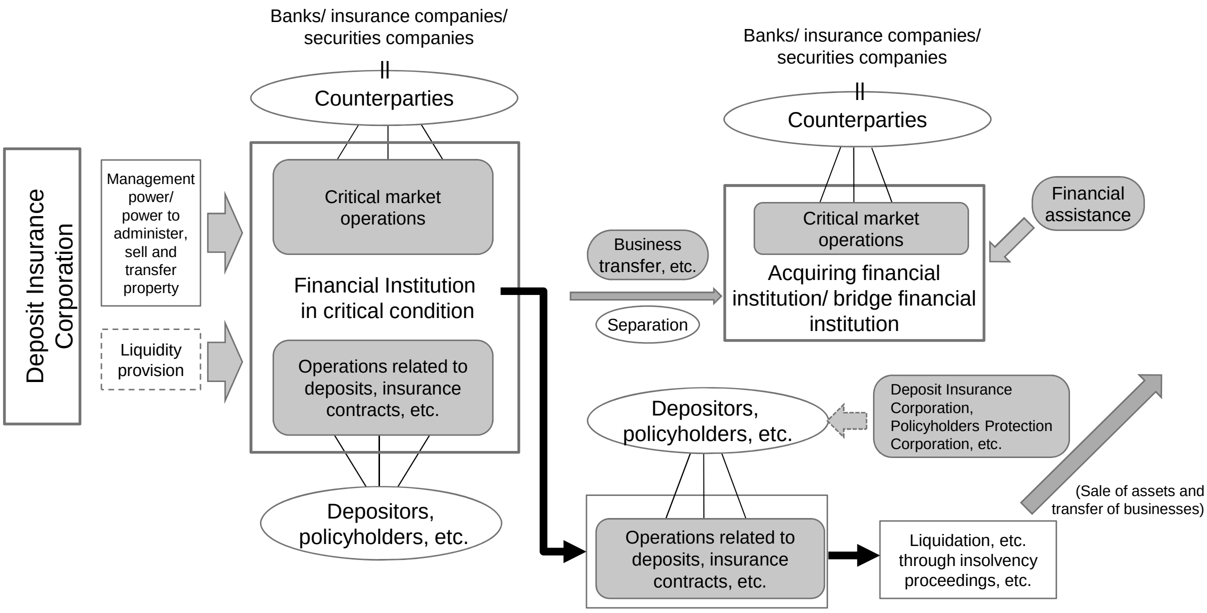
21 Special administration as a rule lasts for a one-year period, but can be extended up to another year if circumstances make it impossible to end.

Figure 1: Resolution scheme when not meeting the insolvency and other conditions (Item 1 special measures)



Source: Financial Services Agency (Explanatory material submitted to the Diet with draft legislation)

Figure 2: Resolution scheme when meeting the insolvency and other conditions (Item 2 special measures)



Source: Financial Services Agency (Explanatory material submitted to the Diet with draft legislation)

Under Item 2 special measures, to try to stabilize the system, systemically important claims are taken over by an acquiring financial firm, or by a bridge financial institution if an acquiring financial firm cannot be found, while deposits and insurance policies are resolved using the appropriate mechanism, be it deposit insurance or the Life Insurance Policyholders Protection Corporation of Japan, and the assets and businesses left over are liquidated under bankruptcy proceedings (Figure 2). That is, under Item 2 special measures systemically important transactions are taken over by an acquiring or bridge financial firm, the protections offered by the existing safety net are applied, and the remaining parts of the firm are liquidated under a closed bank resolution scheme. The DICJ, acting as the bridge financial institution, takes over the debt of the financial firm placed under special oversight and to ensure the smooth repayment of debt can establish a specified bridge financial institution, etc. (including a specified bridge bank, specified bridge insurance company, or specified bridge FIBO (Article 126-34)[22].

With a specified merger under Item 2 special measures, there is a merger between a failed financial firm and another financial firm, the sale of a failed financial firm's business to another financial firm, the underwriting of all or a portion of a failed financial firm's debt by another financial firm, the acquisition of the stock in a failed financial firm by another financial firm, or all or a portion of the rights and obligations of a failed financial firm are taken over, either through an absorption-type company split or a consolidation-type merger (Article 126-28(2)), and specified financial assistance is provided in order to assist the specified merger (Article 126-28(1))[23]. In this case, the Prime Minister must provide certification, namely specified eligibility certification (Article 126-29(1))[24]. Specified financial assistance shall be as needed to create the specified merger, based on the financial position of the failed financial firm, and unlike in the case of financial assistance related to limited protection, where the criteria is an amount equivalent to the payoff cost, there is no specific figure cited. This may be because Item 2 special measures use both deposit insurance and the Life Insurance Policyholders Protection Corporation of Japan, making it difficult to come up with a single standard.

There is also a provision under Item 2 special measures for the DICJ to provide liquidity in order to avoid market turmoil. Namely, the DICJ may, if it deems it

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[22] A specified bridge financial institution, like a bridge bank, is authorized in principle to exist for two years, but that can be extended for up to another year if circumstances make it impossible to close.

[23] Specified financial assistance is defined to include (1) monetary grants, (2) the lending and deposit-taking of funds, (3) the outright purchase of assets, (4) the guarantee of debt, (5) the assumption of debt, (6) the underwriting of specified preferred stock, etc. and (7) security for damages. After conducting a specified merger, the rescued financial firm is allowed to receive additional specified financial assistance (Article 126-32). Even when a merger is executed to provide an exit from the bridge financial institution, measures are taken to provide specified financial assistance to the rescuing financial firm (Article 126-38).

[24] Specified eligibility confirmation is granted when three conditions are met: (1) the creation of a specified merger would contribute to the orderly resolution of the assets and liabilities of a failed financial firm, (2) specified financial assistance is essential to creating a specified merger, and (3) the full cessation of the failed financial firm's business or the dissolution of its debts would risk serious turmoil in Japan's financial system.

necessary in order to repay those obligations of a type that if defaulted on would put Japan’s financial system at risk of extreme turmoil, provide loans to financial firms placed under special administration and failed financial firms that have initiated the bankruptcy, reorganization, or rehabilitation process, if approved by resolution of its Steering Committee (Article 127-2(1))[25]. If such a loan is made to a failed financial firm that has begun bankruptcy, reorganization, or rehabilitation procedures, the rules allow for the repayment of the type of debt that the court deems that if defaulted on would put Japan’s financial system at risk of extreme turmoil, and thus provides for measures that allow for the court to grant an exception to the Bankruptcy Act, Corporate Reorganization Act, and Civil Rehabilitation Act with a view toward avoiding market turmoil and authorize the repayment of systemically important debts (Article 127-4(1)).

Furthermore, to avoid a drop in the value of credit claims and other assets held by financial firms that have been put under special administration, the DICJ may provide loans after an application has been submitted to begin the bankruptcy, reorganization, or rehabilitation process (Article 128-2(1)).

3) Paying for the costs related to Special Confirmation

When there are costs involved in implementing crisis measures for a financial firm that has been subject to Special Confirmation, financial firms will be charged a special levy, and thus the costs are covered by the industry ex post (Article 126-39(1)). The amount of this special levy is computed for each financial firm by dividing their total liabilities at the end of the previous fiscal year by 12 to get a monthly amount, multiplying that by the number of months in that fiscal year up until the day the special levy must be paid, and then applying a fixed rate to that amount. Certain liabilities designated by government order are excluded from the amount of liabilities used in the calculation, however. The BRWG report notes that the benefits provided by the safety net and the nature of the business should be taken into account when calculating the special levy, and that insured deposits covered by the existing safety net should be excluded from the total liabilities used in the calculation.

Nevertheless, the government can subsidize a portion of resolution costs, thereby providing a backstop, when Japan’s financial markets and other aspects of its financial system are deemed at risk of extreme turmoil if the costs incurred in the crisis measures are covered solely by the special levy, (Article 125(1)).

Work on measures related to the new resolution regime shall be accounted for separately under the Crisis Management Account, as is stipulated for financial crisis measures in Article 102 of the DIA (Article 18-2 of the Supplementary Provisions).

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25 Loans to failed financial firms in the process of bankruptcy, reorganization, or rehabilitation shall be deemed as having been made prior to the decision to initiate bankruptcy, reorganization, or rehabilitation proceedings for purposes of determining the relationship between the DICJ and other creditors (Article 127-2(3)).

4. Other measures

1) Bail-in measures

The new resolution regime also includes provisions for a bail-in as required in the FSB's Key Attributes. The BRWG report seeks to focus the losses from orderly resolution on the financial firm's creditors, and thus argues that a contractual bail-in is appropriate.

The revised DIA, while limited to financial firms designated by administrative order, calls for a bail-in under authority of the Prime Minister, with the Prime Minister deciding on the treatment of equity capital and other equivalent instruments at the time of Special Confirmation, if there is an issuance of (1) stock acquired by financial firms on condition of Special Confirmation (instruments with a priority on the allocation of dividends or property rights), (2) subordinated bonds that are written down or acquired by financial firms on condition of Special Confirmation (corporate bonds with special terms subordinating their principal and interest payments), or (3) subordinated loans that are written down or acquired by financial firms on condition of Special Confirmation (a loan with special terms subordinating its principal and interest payments) (Article 126-2(4)).

Additionally, the revised DIA stipulates that if financial firms for which the financial crisis measures described in Article 102 have been applied issue (1) stock acquired by financial firms on condition of Confirmation under Article 102, (2) subordinated bonds written down or acquired by financial firms on condition of Confirmation under Article 102, or (3) subordinated loans written down or acquired by financial firms on condition of Confirmation under Article 102, the Prime Minister will decide on the treatment of equity capital when giving said certification (Article 102(1)(3)). A bail-in is thus used even when Article 102 is invoked.

Stock, subordinated bonds, and subordinated loans subject to bail-in from Special Confirmation or Confirmation under Article 102 shall be treated as capable of contributing to financial soundness, reflecting the criteria that determine whether equity capital and other financial measures are suitable levels as stipulated in the Banking Act and other laws and regulations. In other words, these are capital instruments that count toward capital requirements. Senior debt that is not included in capital requirements is not subject to bail-in.

New bail-in instruments acquired by the issuing financial firm or with special terms of debt write-down used as a trigger for Special Confirmation or Confirmation under Article 102 can be legally bailed in in accordance with the special terms, even when not insolvent, if Special Confirmation or Confirmation under Article 102 is given[26]. Although the revised DIA does not make such special terms compulsory

[26] There are also certain administrative orders under which it is clearly stated that bail-in does not apply, namely, as in Article 126-2(4), those financial firms noted in each subsection of paragraph 4 for which Special Confirmation is attempted pursuant to administrative orders from the Cabinet Office or Ministry of Finance, and, as in Article 102(3), those financial firms noted in each subsection of paragraph 4 for which Confirmation is attempted pursuant to administrative orders from the Cabinet Office or Ministry of Finance.

when financial firms issue capital securities, it will probably be necessary moving forward to confirm the requirements of capital instruments used as regulatory capital pursuant to the Banking Act and other laws and regulations[27].

2) Suspending the initiation of early termination rights

The Key Attributes argue that the resolution authority must have the power to place temporary stays on early termination rights in derivative contracts and other financial contracts. Clauses allowing for the termination (including special termination) of agreements (those transactions with relevance to financial markets and other aspects of the financial system that are stipulated in ministerial ordinances) for reasons related to a Special Confirmation, an order for special administration, or measures taken related to the Special Confirmation, can be ruled nonbinding for a period determined by the Prime Minister, following deliberation by the Council for Financial Crises, for purposes of avoiding the risk of extreme turmoil in Japan's financial system (Article 137-3)[28].

In this case, special termination includes the ending or termination of the agreement, the right to terminate the agreement, acceleration clauses, netting based on the Collective Liquidation Act, and similar items included in Ministerial ordinances. In other words, because early termination rights are deemed valid under the Collective Liquidation Act, Bankruptcy Act, Civil Rehabilitation Act, and Corporate Reorganization Act, the early termination rights in derivative agreements can be suspended under authority of the Prime Minister in order to suspend the validity of private law agreements.

3) Measures supporting orderly resolution

If the resolution process for a failed financial firm is initiated by its creditors, there is a risk that this could impede an orderly resolution. In that respect, in the event that there is an application for approval to begin the process for bankruptcy, reorganization, rehabilitation, special liquidation, or foreign bankruptcy resolution, the revised DIA provides an opportunity for the Prime Minister to express an opinion to the Court regarding the decision on the application and/or the timing of the order. To deal with compulsory execution, creditors are prohibited from seizing those assets and credit claims that are related to the business of a financial firm for which Item 2 special measures have been applied and that are being assumed by or transferred to a rescuing financial firm engaging in a special merger, and procedures are in place to facilitate the assumption or transfer of credit claims to the rescuing financial firm (Article 126-16).

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27 At the 14th meeting of the BRWG, FSA's Secretariat commented, "although Basel III allows for "point of viability" credit claims that count toward regulatory capital, we think these are also included, and nothing is written that says some incentive should be offered beyond that."

28 These measures also apply in relation to the financial crisis measures outlined in Article 102 of the DIA.

On the other hand, there is a possibility that when businesses or credit claims are assumed by or transferred to a rescuing financial firm, the shareholder approval required by the Companies Act will prevent speedy resolution. Under the revised DIA, in the event that a financial firm under special oversight meets the conditions of being insolvent, being at risk of becoming insolvent, having stopped payments, or being at risk of stopping payments, it is possible to gain the court's permission to substitute for certain clauses requiring special resolution at a general shareholders meeting, including the complete or partial transfer of the business, company split, reduction in capital, or transfer of insurance policies (Article 126-13(1))[29]. With the court's permission to substitute, it is also possible to remove and replace the executives of financial firms placed under special oversight (Article 126-4).

The revised DIA also provides the ability to omit procedures aimed at protecting creditors when transferring a business. Specifically, when there has been a decision to provide special financial assistance to help with the transfer of a business or the underwriting of an obligation under Item 2 special measures, said transfer or underwriting can be done without the permission of creditors, neither the creditors with a claim on the debt being assumed by the rescuing financial institution via the transfer of business nor the creditors with a claim on receivables with a contractual prohibition on transfer being assumed by the rescuing financial institution (Article 131)[30]. In addition, it attempts to simplify procedures that could impede the speedy transfer of the business, providing for exceptions in the procedures for changing the trustee in the event of a trust business being assumed, for transferring the status of a trustor, for transferring custody when an account-handling institution transfers its business, and for transferring revolving mortgage claims.

It also has provisions to facilitate resolution. When recovering the credit claims of financial firms who are creditors of financial firms placed under special oversight or otherwise exercising the claims of creditors designated by ministerial ordinance is deemed to threaten or be at risk of threatening the orderly resolution of assets and liabilities, the DICJ must demand that said credit claims on said financial firms not be exercised until the business is transferred or other necessary measures are taken to avoid extreme turmoil to Japan's financial system (Article 126-14). The DICJ must advise financial firms not to recover credit claims in a disorderly manner.

Additionally, the Prime Minister can, when deeming it necessary to facilitate the orderly resolution of a financial firm's assets and liabilities, order financial firms with Special Confirmation to keep assets in Japan and to ring fence assets as necessary to protect creditors (Article 126-17). When the orderly resolution of a financial firm's assets and liabilities is required and the measures needed to ensure their smooth implementation are deemed not to have been taken, the Prime Minister can also order

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[29] If a financial firm becomes insolvent, the current law provides for measures to reduce capital or transfer/dissolve of all or a part of the business, acts that normally require special resolution at a general shareholders meeting, upon receiving the court's permission to substitute.

[30] The same treatment applies in the case of transferring a business or insured deposits under the financial assistance approach.

the financial firm to take measures to the extent necessary by a specified deadline (Article 137-4).

4) The DICJ's powers

The FSB's Key Attributes aim to achieve orderly resolution across borders. To that end, it recommends establishing Crisis Management Groups (CMGs) comprised of the home and key host country authorities of the G-SIFIs to facilitate information sharing among the countries. Reflecting this, the revised DIA stipulates that when international coordination is required, the DICJ shall exchange information with other governments and authorities and carry out other business as necessary (Article 137-5).

Additionally, while the current DIA gives DICJ staff the right to conduct on-site inspections of banks when deemed necessary by the Prime Minister, the revised DIA authorizes such on-site inspections at securities firms, insurance companies and other financial firms besides banks (Article 137).

IV. Key questions and future challenges

We conclude with a summary of the key questions about, and future challenges of, measures that can achieve the orderly resolution of financial firms' assets and liabilities while maintaining financial system stability.

1. Questions about the orderly resolution framework

With its revision of the DIA, Japan is maintaining the existing resolution regime for bank failures while adding the capability to respond to market-propagated crises. In a cross-country comparison of resolution regimes, Japan stands out by clearly delineating its prescriptions for traditional bank-based systemic risk and those for market-based systemic risk.

In devising its new resolution scheme, Japan has taken into account the international debate over resolution regimes sparked by the global financial crisis, in particular by aiming for consistency with the FSB's Key Attributes. This new resolution scheme is admirable in that it extends the framework for orderly resolution to non-bank financial institutions, including securities firms and insurance companies, that previously lacked a framework, while making that framework more robust by going beyond the traditional thinking behind bankruptcy law, which revolves around legal entities, and striving for resolution at the group level, including holding companies and group subsidiaries.

Particularly worth noting is that the DICJ can now provide liquidity in its process of seeking orderly resolution while avoiding market turmoil. The Key Attributes emphasizes making shareholders and creditors bear the costs of resolution, typified by its bail-in measures, and also limiting the use of public funds to reduce the moral hazard associated with too-big-to-fail. On the other hand, the financial panic that ensued following the failure of Lehman Brothers was amplified by a lack of market liquidity and failure of markets to function, while the new resolution scheme focuses on keeping markets liquid by using public funds to provide liquidity support to the affected financial firms.

In the past, failed financial institution in the resolution process were provided liquidity in the form of special loans from the BOJ acting as the lender of last resort (LLR), but under the new resolution scheme the DICJ is the main provider of liquidity[31]. Based on the experience of the financial crisis, the focus is now on a central bank's role as the market maker of last resort (MMLR), which it performs by maintaining market functionality and restoring market liquidity by providing liquidity to markets when that liquidity has declined[32]. There is a need to delineate the respective LLR and MLR roles played by the BOJ and the DICJ in the process of providing that liquidity[33].

Meanwhile, the establishment of a speedy administration is essential to achieving orderly resolution. In this regard, constitutional restrictions related to property rights pose a substantial barrier in Japan to administrative procedures that change the rights of creditors, and the new resolution scheme, like the current scheme, while using administrative procedures by the DICJ as the base, also applies bankruptcy laws through the court system in parallel for cases of insolvency in which credit claims are reduced[34]. Additionally, the new resolution scheme is implemented as needed in parallel with existing safety nets, including deposit insurance, the Japan Investor Protection Fund, and the Life Insurance Policyholders Protection Corporation of Japan. Accordingly, to achieve orderly resolution both quickly and smoothly, the details of resolution procedures need to be simulated to ascertain the resolution scheme's treatment of holding companies, regulated subsidiaries, and nonregulated

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31 Under Article 38 of the Bank of Japan Act, the BOJ, may at its discretion lend funds on special terms or take other actions it deems necessary to maintain credit stability, provided that the Prime Minister or the Minister of Finance deems it necessary to maintain credit stability and request the BOJ to do so.

32 Examples of central banks acting as a MMLR include the Fed, which after the failure of Lehman Brothers introduced a policy program to provide liquidity to issuers of CP and holders of ABS, and the ECB, which dealt with the European debt crisis by purchasing the government bonds of euro zone member countries through its Securities Markets Programme. Additionally, the BOJ purchased CP, asset-backed CP, and corporate bonds to deal with the rapid decline in liquidity of the CP and corporate bond markets caused by the financial crisis (see the 22 April 2013 speech by Hiroshi Nakaso, "Financial Crises and Central Banks' "Lender of Last Resort" Function," Remarks at the Executive Forum Hosted by the World Bank "Impact of the financial crises on central bank functions" (*available at* http://www.boj.or.jp/en/announcements/press/koen_2013/data/ko130423a1.pdf).

33 The DICJ can borrow funds from the BOJ or financial firms and may also issue DICJ bonds, and we think there is a need to establish ex ante the source of the liquidity provided.

34 This problem was also pointed out by the Banking Regulation Working Group. For example, its chairman, Shinsaku Iwahara, a professor of law at the University of Tokyo's Graduate School for Law and Politics, said at the fifth meeting, "Because of Japan's constitution, I think there is a stronger tendency in Japan to view it as essential to go through the court system to make major changes to the rights of creditors than is the case in the US."

subsidiaries, while there is a need to provide specific mechanisms to link the DICJ's efforts with those of the court, as well as of the Japan Investor Protection Fund and Life Insurance Policyholders Protection Corporation of Japan. Additionally, to avoid counterparty turmoil, there is a need to ascertain, in coordination with overseas authorities, the impact from temporary stays on early termination rights under the Prime Minister's authority[35].

Furthermore, when formulating resolution strategies, there is a need to coordinate with the recovery and resolution plans (RRPs), particularly the resolution plans, of G-SIFIs that have been requested to formulate such plans. Because cooperation among authorities in and outside of Japan is essential to the resolution process of a G-SIFI, we think the DICJ needs to strengthen its ties with those authorities with a responsibility for G-SIFIs, while also becoming more involved in the G-SIFIs' recovery and resolution planning process.

Once it becomes clear that such mechanisms can ensure the speedy and smooth implementation of the new resolution scheme without creating market turmoil, it will win the trust of market participants, financial firm creditors, and counterparties, which in turn will help to avoid disorder and turmoil, thereby contributing to the process of orderly resolution. It is necessary to improve the ability during normal times to predict the feasibility of orderly resolution and gain the sufficient understanding of market participants.

2. Alignment with the Key Attributes

The FSB announced its initial peer review on resolution regimes in April 2013[36]. The peer review does not go as far as evaluating compliance with the Key Attributes among the G20 countries, but merely surveys each country's regime benchmarked against the Key Attributes. It reiterated its proposal that each country adopt the requirements outlined in the Key Attributes, and there is a possibility in the future that it will look more closely at the alignment of Japan's resolution regime with the Key Attributes.

Of interest in this regard is the bail-in. Bail-in as defined in the Key Attributes applies to stock as well as unsecured and uninsured credit claims, including senior debt. In contrast, bail-in under Japan's new resolution scheme is limited to equities and subordinated debt securities, which are capital securities that count as regulatory capital. Additionally, the Key Attributes envision a statutory bail-in implemented under the legal powers of the resolution authority, in contrast with Japan's new

[35] For example, testifying on cross-border resolution before the Subcommittee on National Security and International Trade and Finance (Committee on Banking, Housing, and Urban Affairs, US Senate, 15 May 2013), Michael Gibson, a director at the Federal Reserve Bank noted that the power to place a temporary stay on early termination rights included in the Dodd-Frank Act may not apply outside of the US and that the effectiveness of applying that power in other jurisdictions needed to be confirmed (*available at* http://www.federalreserve.gov/newsevents/testimony/gibson20130515a.pdf).

[36] FSB, "Thematic Review on Resolution Regimes; Peer Review Report," 11 April 2013 (*available at* http://www.financialstabilityboard.org/publications/r_130411a.pdf).

resolution regime, which provides for a contractual bail-in. The FSA has indicated that it plans to continue studying the idea of introducing a statutory bail-in after taking into account conditions overseas[37]. If Japan introduces a statutory bail-in, it will probably give administrative authorities, including the DICJ, those powers out of consideration for the speediness of resolution, although the challenge would be figuring out how to overcome constitutional restrictions. On the other hand, if Japan does introduce a statutory bail-in it will probably also have to rethink the instruments covered by the bail-in.

Another difference in thinking concerns the resort to public support. The Key Attributes aims to prevent the moral hazard from too-big-to-fail and avoid exposing taxpayers to loss by not relying on public solvency support or creating the expectation that such support will be available, and by building a statutory and policy framework that does not force reliance on public ownership or bail-out funds. Nevertheless, while the principle is to focus the losses from resolution on shareholders and creditors, if the overall system enters a crisis caused by panicky markets and a domino-like failure of market participants, it may be difficult to contain the crisis without public support.

In Japan, recapitalization with public funds and nationalization are financial crisis measures that have already been used on banks, and there are also mechanisms for the government to alleviate the resolution costs imposed on the industry already in place. The new resolution scheme also includes measures for the DICJ to supply liquidity and funds for recapitalization, and provides for government assistance with covering the costs of resolution. Because of lessons learned during Japan's financial crisis in the 1990s, we think the Japanese people understand the need to use public funds to stave off a crisis[38].

3. Future challenges

The revised DIA is Japan's answer to international calls for the orderly resolution of financial firms, particularly the cross-border resolution of SIFIs, but we think several issues remain for the future in regards to achieving orderly resolution that is both timely and smooth.

First, in an argument tangential to introducing statutory bail-in, there are restrictions in Japan on achieving resolution through administrative procedures only,

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37 At the 11th meeting of the FSA Secretariat, Deputy Director-General of Credit Systems Fujimoto noted in regards to statutory bail-in that "for now contractual bail-in will be expressly allowed, and because statutory bail-in is just now being incorporated into statues and has yet to be used in many other countries, and the issues are still being debated in a number of countries, we think it might be best to keep an eye on those developments and continue to study the idea."

38 At its fourth meeting, Working Group Chairman Iwahara noted in regards to imposing costs on taxpayers that "Japan's Deposit Insurance Act was written on the assumption that it was ultimately possible to impose costs on taxpayers, because taxpayers understood that such imposition of costs was necessary after the very bitter experience of the financial crisis in 1998."

and it is conceivable that this could pose a barrier to timely resolution[39]. In the US, the Federal Deposit Insurance Corporation (FDIC) has the powers as receiver to reduce credit claims when resolving banks, and the new resolution regime, Orderly Liquidation Authority (OLA), introduced under Dodd-Frank covering nonbank financial firms (including bank holding companies, broker-dealers, and insurance companies) also gives the FDIC the powers to reduce credit claims in its role as receiver in the resolution process. Meanwhile, the debate in Europe over the EU Recovery and Resolution Directive (RRD) aimed at harmonizing bank resolution regimes in the EU discussed giving bail-in and various other tools to the resolution authority.

In this regard, the Key Attributes request that the resolution authority have the capacity to exercise the resolution powers with the necessary speed and flexibility, subject to constitutionally protected legal remedies and due process. In Japan, there may be a point in the future when it becomes necessary to fundamentally revise the current framework, which, with a view toward ensuring timely and flexible resolution and in light of financial system stability being in the public interest, provides for two layers of procedures, administrative and judicial, based on exceptional measures provided for under bankruptcy laws, including a procedure whereby resolution is entrusted to administrative procedures initiated by the DICJ, with an ex-post review by the judiciary[40].

Although not proposed in the Key Attributes, it also provides for earlier intervention, either with oversight or a resolution trigger, to contribute to orderly resolution. This is based on the idea that intervention by the authorities at an earlier stage avoids situations in which the bank cannot remain a going concern and would make rehabilitation and business restructuring that much more likely. In that regard, the EU's RRD attempts to introduce a special management regime as a mechanism for early intervention. When special management is invoked prior to resolution being triggered, the special administrator chosen by the regulators acts in place of management to take the steps needed to put the financial firm back on a sound footing. On the other hand, the FDIC in the US can perform due diligence and choose a

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39 The goal of resolution under the DICJ is a "Friday to Monday" procedure, meaning to initiate resolution after the close of business on Friday and reopen for business on Monday, and any judicial proceedings aimed at reducing credit claims are conducted after that. Resolution of the Incubator Bank of Japan was initiated on Friday, 10 September 2010, went through the weekend, and on Monday, the 13th, 16 of 101 branches were reopened and payment on insured deposits began. Judicial procedures began the same day, when the Tokyo District Court initiated civil rehabilitation procedures. Later, in April 2011, a portion of the business was transferred to The Second Bridge Bank of Japan, and then in December that year it was transferred to the final acquiring entity, Aeon Bank. Meanwhile, the Incubator Bank of Japan, already in the rehabilitation process, made its first repayment based on its rehabilitation plan (with a repayment rate of 39%), while uninsured depositors were paid starting in April 2012.

40 For example, one of the conditions in the consultative document released ahead of the Key Attributes noted that from the perspective of maintaining timeliness and flexibility, when credit claims affecting the financial system's stability lose value, an ex-post judicial review should be implemented, and the resolution authority should not fail to implement measures that are within the legal powers given to it (*available at* http://www.financialstabilityboard.org/publications/r_110719.pdf).

potential acquiring financial firm before appointing a receiver. Additionally, the Dodd Frank Act provides for an early remediation requirement, which enables even earlier intervention than is possible with prompt corrective actions (PCA) based on capital requirements.

Because the new resolution regime deals with market-based systemic risk, we think there is a possibility that judgments based on PCA under traditional capital requirements would be too late to act as its trigger. There is probably a need to look more closely at exactly what sorts of triggers should be used to initiate the new resolution scheme.

4. New issues being discussed in Europe and the US

Separate discussions on resolution regimes moving forward in the EU and US also bear watching. The RRD being considered in the EU is generally in line with the Key Attributes, while the US and the UK are crafting their own resolution strategies, at the same time coordinating between them. The FDIC and Bank of England (BOE) are both looking at single-point-of-entry approaches (called single receivership in the US and top-down resolution in the UK) that apply bail-in to the ultimate parent companies and holding companies of G-SIFIs, focusing losses on their shareholders and creditors while ensuring that critical subsidiaries remain going concerns. Under this resolution strategy, there are differences among the shareholders and creditors of holding companies and subsidiaries in their ability to preserve rights.

In addition, depositors' claims take precedence over general credit claims. This is based on thinking that because small depositors have less access to information than large creditors, they should have priority in the claims hierarchy. In the US, Congress passed the Omnibus Budget Reconciliation Act in 1993, which gave claims on deposits, including uninsured deposits, priority over unsecured credit claims. In the EU's discussions aimed at finalizing RRD, the European Parliament and the Council of the Europe Union have agreed separately to exclude insured deposits below €100,000 from bail-in and other resolution tools and to give uninsured deposits, including deposits of at least €100,000 priority over general credit claims[41].

In Japan, insured depositors are protected by the DICJ, while uninsured depositors, based on the principle of equal treatment of creditors, are paid off on a pro rata basis with the same priority as general creditors. Consequently, because uninsured deposits (including principal amounts exceeding ¥10 million) are given equal treatment to general credit claims under current resolution procedures, it takes a while before receiving payment under court-ordered proceedings[42]. It may be worthwhile for Japan

41 For more on the European Parliament's agreement to give priority to depositors, see European Parliament, "Taxpayers and Savers Last in Line to Save Banks," Committee on Economic and Monetary Affairs, 21 May 2013. On the Council of the Europe Union's agreement to give priority to depositors, see Council of the Europe Union, "counseling degrees position on bank resolution," Brussels, 11228/13, press 270, 27 June 2013.

42 See the history of the Incubator Bank of Japan resolution described in footnote 39.

to consider depositor preference to avoid imposing excessive losses on uninsured depositors.

Moving forward, we expect the G20 countries, including Japan, to come under more explicit pressure to harmonize their systems with the Key Attributes, via the FSB's peer review process. Meanwhile, Western countries are moving forward in establishing their own ways of dealing with areas not addressed by the Key Attributes. Although legislation has been passed in Japan, it will be important to watch moving forward which mechanisms within its cross-border resolution regime move in the direction of convergence and which move in the opposite direction.