

New orderly resolution regimes for financial institutions under the amended Deposit Insurance Act of Japan – JFSA releases response in public consultation process

The Financial Services Agency of Japan (the "JFSA") recently responded to questions posed by the public regarding the government enforcement order and ordinances connected to the amended Deposit Insurance Act of Japan (the "DIA"). This briefing summarises the main points under the amended DIA, which came into effect on 6 March 2014, highlighting the views expressed by the JFSA in its responses during the public consultation.

Amendment to the DIA

In response to the global financial crisis, Japan introduced, through an amendment to the DIA, new resolution regimes which will apply to financial institutions across the board. These amendments were in line with the Key Attributes of Effective Resolution Regimes for Financial Institutions (the "**Key Attributes**"), published by the Financial Stability Board. The new regimes cover various types of financial institutions ("**Covered Financial Institutions**") including deposit taking institutions such as banks, insurance companies, type 1 financial instruments business operators involved in securities related business, certain bank holding companies, certain insurance holding companies, designated parent companies under the Financial Instruments and Exchange Act, certain subsidiaries of the financial institutions and holding/parent companies mentioned above, and securities finance companies. The government enforcement order relating to the amended DIA has also added money market brokers (*tanshi gyousha*) to the Covered Financial Institutions.

Special Confirmation

The Prime Minister can confirm that it is necessary to implement special measures with regard to a Covered Financial Institution where there might otherwise be a significant disruption of the Japanese financial market or other financial system ("**Special Confirmation**"). Once Special Confirmation is announced, the Covered Financial Institution will be placed under the special supervision or management of the Deposit Insurance Corporation of Japan (the "**DICJ**") and become subject to the orderly resolutions contemplated under the DIA. Such a Covered Financial Institution will be subject to and be treated under "Special Resolution Regime I" if it is still solvent, or alternatively, "Special Resolution Regime II" if its liabilities exceed or are likely to exceed its assets or it suspends or is likely to suspend its payments.

Special Resolution Regime I

Under Special Resolution Regime I, the Covered Financial Institution will maintain its management and operations under the special supervision of the DICJ, and continue to perform its obligations, supported by the enhanced liquidity and capital reinforcement (subscription for shares, etc.) provided by the DICJ. The premise of Special Resolution Regime I is that the Covered Financial Institution is still solvent, and the focus is on causing the Covered Financial Institution not to become insolvent.

Special Resolution Regime II

Under Special Resolution Regime II, the DICJ takes over the management of the Covered Financial Institution. Under its management, the Covered Financial Institution will transfer its systemically important transactions to a bridge financial institution or an acquiring financial institution, and such solvent financial institution will continue to carry out the relevant transactions in accordance with their original terms. Other transactions and obligations will remain with the Covered Financial Institution and be liquidated through legal insolvency proceedings, typically civil rehabilitation proceedings.

Temporary stay of early termination/netting clauses

One concern regarding Covered Financial Institutions for which Special Confirmation has been announced is that the conferring of such status may itself trigger early termination clauses under certain derivative or other transactions they have entered into, which may in turn cause instability in the financial markets. To prevent this, the amended DIA provides that the Prime Minister may suspend early termination clauses triggered by (i) Special Confirmation, (ii) confirmation under the existing regime ("**Confirmation**") or (iii) the implementation of any measure relating to Special Confirmation or Confirmation, in respect of certain agreements designated by the Prime Minister, for a period of time he/she deems necessary.

Agreements subject to temporary stay

The temporary stay mentioned above is applicable to "agreements entered into by a Covered Financial Institution for transactions of goods with a quotation on an exchange or any other market quotation, or any equivalent transactions, from among transactions relating to the financial market or other financial system", and includes transactions in respect of exchange-traded or OTC derivatives. However, the interpretation of the scope of "with a quotation on an exchange or any other market quotation...from among transactions relating to the financial market or other financial system" is not entirely clear. The JFSA has indicated that the temporary stay may apply to a wider scope of agreements for transactions perhaps not necessarily limited to financial transactions, and, therefore, there is a possibility that the temporary stay will be broadly applied depending on the actual circumstances of the case.

Events triggering early termination

Where (i) Special Confirmation, (ii) Confirmation or (iii) the implementation of any measure relating to Special Confirmation or Confirmation, triggers an early termination, such early termination may be subject to a temporary stay. According to the JFSA's response in the public consultation process, measures under insolvency proceedings related to Special Confirmation or Confirmation are also included in (iii) above. Therefore, an early termination triggered by a petition for insolvency proceedings related to Special Confirmation or Confirmation may be subject to a temporary stay.

Early termination

Early terminations subject to temporary stay include the following:

- termination or cancellation of the agreement;
- entitlement of a counterparty to the agreement to terminate the agreement;
- acceleration of the agreement; or
- netting of the transactions under the Netting Act of Japan.

In addition to the above, the enforcement ordinances added the netting of transactions which automatically occurs without either party's active intention. Furthermore, the JFSA has indicated that, depending on how the relevant provisions are drafted, it is possible that not only acceleration itself but other effects caused by the occurrence of an acceleration event could also be subject to a temporary stay.

Temporarily stayed transactions

The JFSA has indicated that, in principle, all transactions which have been subject to a temporary stay would be transferred to a bridge financial institution or an acquiring financial institution.

Period of stay

The amended DIA only provides that the Prime Minister can designate "the period of time necessary to take necessary measures to prevent the possibility of the occurrence of a significant disruption of the financial system in Japan". No specific period of the temporary stay is defined under the DIA and its enforcement order and ordinances. The JFSA has published the view that the Prime Minister should determine the period of temporary stay on a case-by-case basis with a view to ensuring effective resolution of the financial institution, bearing in mind the aim of the Key Attributes, which provide that the temporary stay should be strictly limited in time (for example, a period not exceeding two business days).

Funding of the resolution regime

Under the new regime, the DICJ is able to resolve financial institutions for which Special Confirmation has been announced by providing financial support etc. Losses incurred by the DICJ in providing such financial support will, in principle, be borne by all the Covered Financial Institutions irrespective of the failing financial institution's type of business.

A special levy will be calculated for each Covered Financial Institution based on the amount of debt on its balance sheet as of the end of the immediately preceding fiscal year after deducting certain debts designated in the enforcement ordinances.

An example of debts deducted for the purposes of the calculation include allowances for retirement benefits for employees, certain defined reservations for financial instruments transactions, deferred tax liabilities, basic deposits for settlements, basic general deposits covered by deposit insurance, part of the reserves for insurance contracts and debts containing "bail-in" clauses. After the public consultation procedure, cash deposited by customers which is covered and protected by the Investor Protection Fund was added to the debts which would be deducted.

Also, an enforcement ordinance of the Banking Act will be amended with respect to the accounting of foreign bank branch offices in Japan, and a part of inter-office accounts which was treated as debts but has the nature of equity will be treated as "Brought-in Capital" as an item in net assets rather than debts. Therefore such amounts would be effectively deducted from the calculation as well.

However, it has been indicated that debts owed by companies which belong to certain foreign financial groups (which are not consolidated from a Japanese accounting perspective) to other companies within such group and debts invested in relatively secure assets such as cash or Japanese Government Bonds are not excluded from these debt calculations.

Furthermore, it has been confirmed that a foreign bank branch office in Japan will not be a paying party to pay other group financial institutions' special levies and the special levy of the branch office will not be paid by other group financial institutions. The debt amount used for a foreign bank branch office in Japan is the debt in the balance sheet of such branch office in Japan rather than the debt in the balance sheet of the entire foreign bank to which such branch office belongs.

Bail-in

Under the amended DIA, the Prime Minister has the power to confirm how certain subordinated debts and preference shares containing contractual bail-in clauses should be treated under the capital adequacy rules. It should be noted that through the public consultation process, the JFSA confirmed that the Prime Minister will not have the power to treat these debts and shares differently to the manner they are treated in their contractual bail-in clauses. Therefore, it is considered that the amended DIA has not adopted a "statutory bail-in" approach.

Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.

Contacts

If you would like to know more about the subjects covered in this publication or our services, please contact:



Masayuki Okamoto
Partner

T: +(81 3) 5561 6665
E: masayuki.okamoto
@cliffordchance.com



Leng-Fong Lai
Partner

T: +(81 3) 5561 6625
E: leng-fong.lai
@cliffordchance.com



Satoshi Nomura
Counsel

T: +(81 3) 5561 6312
E: satoshi.nomura
@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

Clifford Chance, Akasaka Tameike Tower, 7th Floor, 2-17-7 Akasaka, Minato-ku, Tokyo 107-0052, Japan

© Clifford Chance 2014

Clifford Chance Law Office (Gaikokuho Kyodo Jigyo)

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Jakarta* ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh ■ Rome ■ São Paulo ■ Seoul ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

* Linda Widyati & Partners in association with Clifford Chance.