

Orderly Resolution of Financial Institutions – Amendments to the Deposit Insurance Act of Japan

A new orderly resolution regime for financial institutions was introduced by the amendment to the Deposit Insurance Act of Japan (the "DIA") and other Acts enacted in June 2013. The new regime establishes a framework for dealing with a financial crisis caused by severe market disruptions. The new regime aims to strengthen the financial markets and financial industry in Japan.

Background

Following the bankruptcy of Lehman Brothers in 2008, the G20 member countries resolved to establish orderly resolution regimes for financial institutions in order to prevent a recurrence of the 2008 financial crisis.

In October 2011, the Financial Stability Board published a paper entitled "Key Attributes of Effective Resolution Regimes for Financial Institutions" (the "**Key Attributes**") to address the "too-big-to-fail" problem. The Key Attributes were endorsed by the G20 member countries as part of the "Policy Measures to Address Systemically Important Financial Institutions" developed at the Cannes summit in November 2011.

The Financial System Council (an advisory panel to the Prime Minister of Japan) developed the Japanese response to the G20 orderly resolution commitment through the "Working Group on Framework of Regulations on Banks which Contribute to Stability of the Financial System". In January 2013 the working group published its report recommending the introduction of an orderly resolution regime in Japan based on the Key Attributes.

Framework of the new regime

Even before its amendment, the DIA provides for a framework addressing financial crises. The existing framework focuses on a financial crisis caused by a bank becoming overwhelmed by non-performing loans, resulting in a concern about its credit risk which then spreads to other banks through bank runs. The new regime focuses on a financial crisis caused by severe market disruptions, where a concern over the credit risk of financial institutions spreads through the financial markets.

The new regime gives the Prime Minister authority to declare and confirm that it is necessary to take special measures with regard to a specific financial institution where there could otherwise be a significant disruption to the financial system. Once the confirmation by the Prime Minister (the "**Specified Confirmation**") is made the failing financial institution is put under the special supervision of the Deposit Insurance Corporation of Japan (the "**DIC**"). Once the Specified Confirmation has been made, the failing financial institution will (i) where it is solvent, maintain its operations and take steps to improve its financial condition under the Item 1 Specified Procedure explained below or (ii) where it is insolvent, be liquidated in an orderly manner under the Item 2 Specified Procedure as explained below.

Under the new regime, the Japanese government is able to provide a guarantee for obligations incurred by the DIC in implementing the orderly resolution process. However, losses incurred by the DIC are, in principle, to be borne by financial industry participants.

An outline of the new regime is as follows:

Covered Financial Institutions

The new orderly resolution regime covers, among others, deposit-taking institutions (e.g., banks), insurance companies, securities firms, bank holding companies, insurance holding companies and designated parent companies (certain parent companies of securities firms).

Resolution Measures

The "Item 1 Specified Procedure" applies to solvent financial institutions and the "Item 2 Specified Procedure" applies to insolvent financial institutions¹.

Solvent Procedure (Item 1 Specified Procedure)

Under the Item 1 Specified Procedure, the DIC supervises and provides liquidity support to the failing financial institution.

- Supervision by the DIC

The DIC may provide advice, instructions and recommendations for the business activities of the failing financial institution. The Prime Minister can order the failing financial institution to take necessary actions based on such advice, instructions or recommendations.

- Liquidity support

The failing financial institution would continue to perform its obligations, supported by liquidity provided by the DIC. If the financial institution has not started to suspend its payments, the DIC may also inject capital as necessary.

Insolvent Procedure (Item 2 Specified Procedure)

Under the Item 2 Specified Procedure, the DIC may control the failing financial institution by obtaining the authority of such institution's management. Under DIC's management, the "systemically important obligations" of the failing financial institution are transferred to and assumed by a solvent financial institution (which may include a bridge institution) and the failing financial institution itself is liquidated in insolvency proceedings.

- Financial support

When the "systemically important obligations" of the failing financial institution have been transferred to and assumed by a solvent financial institution, the DIC can provide financial support to the solvent financial institution.

- Expediting measures for a business transfer

- A failing financial institution can transfer its business without approval of a shareholders' meeting if court approval has been obtained.
- A solvent financial institution can assume the obligations of a failing financial institution without the creditors' consent. However, the assumption of obligations is cancelled if creditors subsequently object.

- Bridge institution

The DIC can establish a "bridge institution" to which the business (including the "systemically important obligations") of the failing financial institution is transferred. A bridge institution is likely to be established when there is no solvent financial institution with any interest in taking over the failing financial institution's business. The DIC would control and manage the bridge institution as a sole shareholder thereof.

Temporary Suspension as to Derivatives' Termination

- Validity of termination clauses

If the failing financial institution has entered into agreements for derivatives and other transactions the Specified Confirmation may trigger early termination of such agreements or transactions. Such terminations would disrupt the orderly resolution process and further damage the failing financial institution's value. To avoid this, the Prime Minister can issue an order to prohibit automatic termination or termination rights from being triggered by the Specified Confirmation for a specified period.

¹ In order to minimise resolution costs, it is desirable for the Specified Confirmation to be made before the failing financial institution becomes insolvent so that the Item 1 Specified Procedure would apply. However, the financial condition of a financial institution might deteriorate rapidly in a financial crisis and the financial institution might become insolvent by the time the Specified Confirmation is made. In such case, the Item 2 Specified Procedure would apply.

Timing of enforcement and further discussion

The amendments to the DIA shall become effective within the 9 months after the 19 June 2013 promulgation (that is, some time no later than mid-March 2014).

International discussions are also developing on how to effectively operate orderly resolution regimes. For example, the Federal Deposit Insurance Corporation and the Bank of England published a report entitled "Resolving Globally Active, Systemically Important, Financial Institutions" in December 2012 which discusses how to implement the "single point of entry resolution strategy" (the resolution strategy to bring measures only to an ultimate parent entity of a financial group). No doubt, in time, such discussions will have an impact on the Japanese orderly resolution regime.

We will continue to keep an eye on developments.

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.

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