

Amendments to the Deposit Insurance Act of Japan

As of March 6, 2014, the amendments to the Deposit Insurance Act of Japan (*Yokin Hoken Hou*) (Act No. 34 of 1971, as amended, the “DIA”) and the subordinate regulations¹ (the “Amendments”) have become effective. This newsletter briefly describes the changes to the resolution regime for failed financial institutions, which changes may also affect other financial institutions.

1. Background - Necessity for the orderly resolution of financial institutions

The international financial crisis that arose after the collapse of Lehman Brothers Holdings Inc. revealed that the failure of a financial institution occupying an important position in the global financial system could have major adverse effects on financial markets and economies throughout the world. Drawing on lessons learnt from the international financial crisis, a paper entitled “Key Attributes of Effective Resolution Regimes for Financial Institutions” developed by the Financial Stability Board (FSB), was internationally endorsed at the G20 Leaders’ Summit at Cannes in November 2011. The purpose of the paper was to consolidate a scheme for the orderly resolution of failed financial institutions.

Originally, the DIA established measures against the fallout of financial crises for only banking institutions (“Measures I”). The DIA included measures to enhance the adequacy of equity capital, financial assistance, and substantial nationalization by the Deposit Insurance Corporation (the “DIC”), which entity is incorporated under the DIA to conduct such operations. These measures were aimed at protecting depositors and preventing the spread of concern over credit risks from one failed banking financial institution to other financial institutions.

However, during the recent international financial crisis, it was shown that breakdowns of not only banking institutions, but also any financial institution which can largely affect the financial system (such as securities firms and insurance companies) would lead to the malfunctioning of financial markets. New measures which address the failures of various financial institutions would have to be established, so as to prevent chain reaction trading halts in the markets, even after the collapse of a key financial institution.

2. Outline of the Amendments

2.1 New measures concerning the resolution of assets and debts of financial institutions to maintain the stability of financial systems

The Prime Minister may, following deliberation by the Financial System Management Council, authorize the implementation of the measures when he finds that, if the following

¹ The Order for the Enforcement of the DIA and the Cabinet Office Ordinance of the DIA

measures are not taken, it may lead to the extreme disruption of the financial market of Japan or other financial systems. Depending on the financial situation of the relevant failed financial institutions, two different types of measures, as indicated below, may be taken. One type geared towards financial institutions not in capital deficit, and the other directed towards those in capital deficit or possible capital deficit.

(1) Measures for financial institutions not in capital deficit (“Measures A”)

These measures are to maintain the stability of markets mainly through ways of decreases and dissolution of trading in markets, and also a provision of liquidity by the DIC to a failed financial institution so as to allow it to continue to perform its obligations.

In particular, Measures A include: (i) special supervision (in which the DIC or an agency of the DIC supervises the conduct of business and the management and dispositions of assets by the failed financial institution); and (ii) the provision of loans and the subscription for shares by the DIC.

(2) Measures for financial institutions in capital deficit or possible capital deficit (“Measures B”)

These measures are to aid failed financial institutions essential to the stability of the financial system. Specifically, the DIC may transfer material obligations of a failed institution to a bridge financial institution, and may on top of that also provide financial assistance.

In particular, Measures B include: (i) special supervision (as referred to in (1)); and (ii) financial assistance by the DIC for a resolution of a failed financial institution, such as a business transfer or merger of a failed financial institution to another financial institution. Additionally, certain special administration measures (including a complete transfer of rights to permit the DIC to conduct the failed financial institution’s business and management and dispositions of the assets therein) can be taken in more severe cases.

2.2 Financial institutions covered under the measures

Measures A and Measures B can cover the entire financial industry, including but not limited to banks, bank holding companies, branch offices of foreign banks, insurance companies, insurance holding companies, securities firms, certain parent companies of security firms etc., securities finance companies and money market brokers.

2.3 Payment of contributions

To cover costs incurred in carrying out the measures, all covered financial institutions shall pay contributions to the DIC after the incurrence of any such costs and government subsidies may be granted only exceptionally. In general, the breakdown of such contributions is determined based on the amount of debt held by each financial institution.

2.4 Other new provisions

(1) Contractual bail-in

For the orderly resolution of a failed financial institution, it is necessary for creditors and shareholders of said institution to shoulder their share of responsibility to some extent.

Accordingly, new provisions have been introduced which grant the Prime Minister the power to trigger a contractual bail-in for the implementation of Measures B. The contractual bail-in is a way to write off debts of an insolvent debtor or to convert these debts into equity where a clause to permit such writing off or conversion is prescribed in advance in the relevant contract.

The bail-in can be carried out only with respect to the following notes, equity and loans:

- (i) Notes and monetary loans with no collateral, and subordinated by contracts for the payment of principal and interests which are planned to expire or to be acquired by a failed financial institution subject to authorization of Measures B; and
- (ii) Preferred equity with no collateral which is planned to be acquired by a failed financial institution subject to authorization of Measures B.

(2) Temporary stays on early termination rights

The simultaneous termination of derivatives in the event of the failure of a financial institution may destabilize financial markets and may also damage the asset values of the financial institution rapidly. This makes the orderly resolution of the financial institution difficult.

To address this, a new provision has been put in place, granting the Prime Minister the power to determine temporary stays on early termination rights provided in certain contracts, such as derivatives, in which a commencement of Measures I, Measures A or Measures B can be a trigger event for an early termination.

(3) Others

Several other important provisions relating to the orderly resolution of failed financial institutions include, *inter alia*,

- (i) A provision which permits the DIC to request creditors of a failed financial institution not to collect on any debts or claims until necessary measures have been taken in order to avoid extreme disruption to the financial system of Japan.
- (ii) A provision which grants the Prime Minister the power to order a failed financial institution to hold certain assets (including cash, certain domestic deposits as designated by the Commissioner of the FSA, loans to residents) in Japan.

- (iii) A provision which grants the Prime Minister the power to decide upon the establishment of a bridge financial institution for the business transfer of a failed financial institution.
- (iv) A provision which grants the Prime Minister the general power to order financial institutions to take necessary measures to ensure the smooth implementation of an orderly resolution of a failed financial institution.

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Contact Information:

Should you wish to receive further information or advice regarding the foregoing, please do not hesitate to contact the authors Takaharu Totsuka, Ryuji Kato or Tomoyuki Tanaka.

Takaharu Totsuka
Partner
Email: takaharu.totsuka@amt-law.com
Telephone: +81-3-6888-1156

Ryuji Kato
Associate
Email: ryuji.kato@amt-law.com
Telephone: +81-3-6888-5665

Tomoyuki Tanaka
Associate
Email: tomoyuki.tanaka@amt-law.com
Telephone: +81-3-6888-4725

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