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Progress toward resolvability to address TBTF problem: 10-year milestone since "Key Attributes"

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The Global Financial Crisis once again highlighted the "too big to fail" problem for systemically important financial institutions, and regulatory reforms since then have been implemented to address the issue. In this report, we focus on the resolution of global systemically important banks (G-SIBs) and highlight the progress since 2011, when the Financial Stability Board (FSB) set out the key elements of effective resolution regimes ("Key Attributes"). Over the past decade, the financial authorities in Japan and Japanese G-SIBs have cooperated to develop public regimes in Japan, build the internal framework in G-SIBs toward resolvability, and ensure effectiveness of the regimes. It is important to prepare for the next potential financial crisis when the financial system is stable, and the financial authorities in Japan will continue to make steady progress on this issue.

Introduction

The Global Financial Crisis has once again highlighted the "too big to fail" ("TBTF") problem for systemically important financial institutions, and reforms for financial regulations and supervisions have been implemented since then to address the issue under the leadership of the G20. In 2011, the Financial Stability Board (FSB) released the "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("Key Attributes"), and financial institutions and financial authorities in each jurisdiction have been making steady progress in line with the Key Attributes.

Last December, the FSB released the 2021 Resolution Report subtitled "Glass half-full or still half-empty?" as the 10-year milestone since the publication of the Key Attributes. The report summarizes international and domestic progress toward resolvability in each jurisdiction during this period.

In this report, we focus on the resolution of global systemically important banks (G-SIBs) and highlight the progress toward resolvability in Japan to address the TBTF problem. We will also present the future direction of efforts to tackle the TBTF problem in line with ongoing international discussions.[1]

Background ("TBTF problem")

After the bankruptcy of Lehman Brothers in September 2008, globally operating large financial institutions fell into credit uncertainty, and this severe financial crisis affected the real economy, resulting in a global recession. Under these circumstances, it was recognized that disorderly failure of large financial institutions could impose extremely serious adverse effects on the stability of financial systems and economies of various countries.

For this reason, the so-called TBTF problem was once again highlighted; large financial institutions may become too big to be allowed to fail and governments are forced to bail them out through the injection of public funds. In the United States, the epicenter of the financial crisis, and in Europe, which was strongly affected by the crisis, many large financial institutions, including investment banks, commercial banks, and insurance companies, were bailed out with the injection of public funds by governments. These bailouts were strongly criticized because taxpayers had to bear losses during the crisis, while shareholders and executives of such financial institutions had enjoyed profits in normal times. It was also recognized that the "implicit government guarantee" to such financial institutions could create moral hazard and give them incentive for excessive risk-taking. Furthermore, it was pointed out that the "implicit government guarantee" could provide inappropriate benefits to large financial institutions, for example, by allowing them to raise funds on favorable terms, thereby distorting the competitive environment in normal times.

In response to this issue, "orderly resolution" regimes have been developed to solve the TBTF problem. First, even when a G-SIB fails, a system-wide impact should be avoided by continuing critical functions through measures such as transferring of main business operations as well as assets and liabilities to a successor financial institution. Second, the burden of losses associated with the resolution should be absorbed by the shareholders and creditors of the failing G-SIB (bail-in) to avoid the burden on taxpayers. In addition, the importance of international coordination against the TBTF problem was once again recognized as the impact of the Lehman bankruptcy spread across the world through financial markets in the globally connected economic and financial system.

Against this backdrop, "orderly resolution" was listed on the agenda at the G20 Washington Summit in November 2008; since then, the FSB -- in which financial supervisory authorities, finance ministries, and the central banks of 25 major countries and regions, the International Monetary Fund (IMF), the World Bank, and the Bank for International Settlements (BIS) participate -- has led discussions and taken actions.

International guidelines

In response to these discussions, the Key Attributes was released by the FSB in November 2011. This outlines the core elements to achieve "orderly resolution" to resolve the TBTF problem. While the overview is shown in Chart 1, three main points can be summarized as follows. The first is to establish resolution authorities for all systematically important financial institutions and have a legal framework that enables effective resolution. The second is to establish a framework that enables effective resolution without relying on nationalization or injection of public funds. The third is to make arrangements among home and key host authorities for cross-border cooperation and maintain a Crisis Management Group (CMG) for each G-SIB to enhance the progress toward resolvability and share relevant information.

From the perspective of ensuring the effectiveness of orderly resolution, jurisdictions are also required to have a process to formulate and update the recovery and resolution plans for each G-SIB, which have to be reviewed periodically at the CMG.

In addition, the Resolution Steering Group (ReSG), which is a subcommittee of the FSB, ensures the smooth implementation of effective resolution regimes in line with the Key Attributes, and the ReSG reviews the progress toward resolvability and develops resolution-related guidelines. The Financial Services Agency (FSA) and the Bank of Japan participate in this subcommittee and contribute to international discussions.

[Chart 1] Overview of Key Attributes

Key Attributes of Effective Resolution Regimes for Financial Institutions

List of core elements to implement "orderly resolution" for global systemically important financial institutions (G-SIFIs)

Main items

- ✓ Jurisdictions should have resolution authorities to exercise resolution powers
- ✓ Resolution authorities should develop a framework not constrained to rely on public ownership or fund
- ✓ Recovery and resolution plans should be prepared in normal times
- ✓ Home and relevant host authorities should form a CMG for each G-SIB
- ✓ The home authority should periodically review the progress toward resolvability

Progress in line with Key Attributes

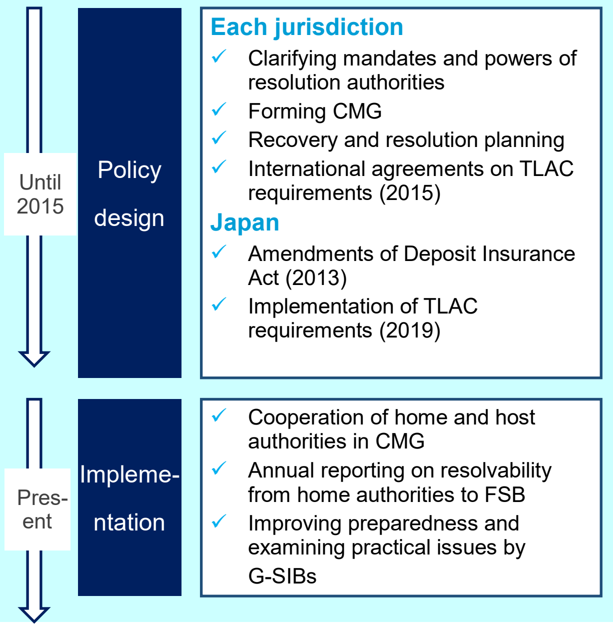
Implementation of orderly resolution regimes

In reviewing the progress of international coordination on the reforms of resolution regimes since the publication of the Key Attributes, it can be assessed that the general framework toward orderly resolution was organized by around 2015. For example, by around 2014, most jurisdictions had clarified mandates and powers of resolution authorities, formed CMG for each G-SIB, and made progress in recovery and resolution planning. In Japan, the Deposit Insurance Act was amended in June 2013 to develop the "orderly resolution" scheme. Furthermore, in light of these developments, from 2014, the FSB began resolvability assessments of each jurisdiction based on reports from national authorities.

In November 2015, to ensure the effectiveness of "orderly resolution," an international regulatory framework was also developed to require G-SIBs to have sufficient loss-absorbing and recapitalization capacity available in resolution, i.e., Total Loss-Absorbing Capacity (TLAC). Under the TLAC requirement, G-SIBs are required to issue a certain level of TLAC-eligible instruments, including common equity, subordinated debt, and "TLAC-eligible" senior debt. In resolution, TLAC-eligible instruments can be written-down or converted into equity by the relevant authority without giving rise to material risk of successful legal challenge or valid compensation claims. As a result, loss absorption and recapitalization can be achieved at the expense of shareholders and creditors of the TLAC-eligible instruments.

Reflecting this steady progress toward resolvability, the FSB released the 2016 Resolution Report subtitled "moving from policy design to implementation." The progress since then has shifted from developing policies to ensuring the effectiveness of resolution regimes.

[Chart 2] Developments of orderly resolution regimes



Overview of orderly resolution scheme in Japan

Next, we present an overview of the "Measures for Orderly Resolution of Assets and Liabilities of Financial Institutions, etc. for Ensuring Financial System Stability (orderly resolution scheme in Japan)" introduced in Japan, through especially focusing on the amendments to the Deposit Insurance Act in 2013. As a prerequisite, we look back at Japan's resolution schemes at the time of the Global Financial Crisis.

At that time, in addition to a resolution scheme that provided protection only to the extent covered by deposit insurance, there were "Measures against financial crisis," which allowed support beyond the coverage of deposit insurance, if it was feared that systemic risk would materialize. "Measures against financial crisis" are stipulated in the Deposit Insurance Act as amended in 2000, based on measures embedded in the Act on Emergency Measures for Revitalization of the Financial Functions and the Act on Emergency Measures for Early Strengthening of Financial Functions in order to address the financial crisis triggered by the non-performing loans problem in the 1990s.

Specifically, three measures ranging from capital injection to temporary nationalization are available depending on the financial conditions of financial institutions. The Prime Minister may, when deeming that "an extremely serious threat is posed to the maintenance of financial stability in Japan or a region where relevant financial institutions are conducting operations," confirm the need to implement these measures, following discussions by the Financial Crisis Response Council, which includes the Prime Minister, the Commissioner of the FSA, the Governor of the Bank of Japan, etc.

The impact of the Global Financial Crisis on Japan's financial system was limited compared to Europe and the United States, and the measures above were never invoked.

However, the Deposit Insurance Act was amended in 2013 to establish a new framework for the orderly resolution in order to prepare for the risk of failures of G-SIBs and other financial institutions propagating through financial markets, while taking into account the lessons learned from the Global Financial Crisis. Specifically, the amendment introduced (1) "Specified Measures Under Item (i)," which provides liquidity and capital injection to financial institutions before they become insolvent, and (2) "Specified Measures Under Item (ii)," which provides the financial assistance when they become insolvent or have failed (or when they are likely to become insolvent or fail).[2] Based on the lessons learned from the Global Financial Crisis, where securities firms and insurance companies, in addition to banks, had a significant impact on the financial system, the scope of the newly introduced orderly resolution covers a wide range of financial institutions, including securities firms and insurance companies, in line with the Key Attributes.

The "Specified Measures" may be triggered when it is recognized that "severe disruption in Japan's financial market and any other financial system may be caused" and the Prime Minister confirms the measure, following deliberation by the Financial Crisis Response Council. The funds necessary for the measures are covered by the balance of the Deposit Insurance

Corporation of Japan (DICJ) and borrowings, which are recorded in the Crisis Management Account of the DICJ, and in the event of a loss, the costs are covered by the contributions from the financial industry in line with Key Attributes.

In addition, the amendment in 2013 allows the Prime Minister to temporarily suspend the right of early termination (stay) to avoid market disruption, so that derivative contracts with a failed financial institution are not cancelled upon commencement of the resolution process.

[Chart 3] Resolution schemes in Japan for systemic risk

(Measures against financial crisis: for banks, etc.)

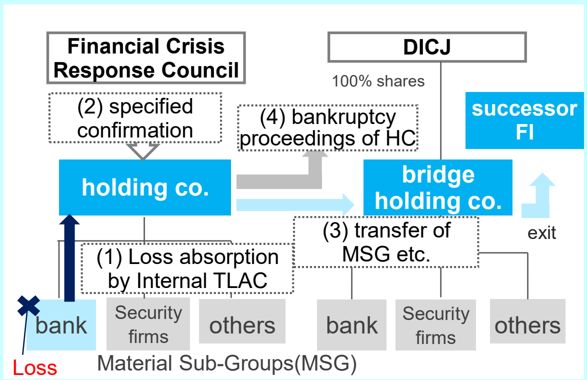
Name	Capital conditions	Measures
Measures Under Item (i)	Inadequate capital	Capital injection
Measures Under Item (ii)	Failed or insolvent	Financial assistance
Measures Under Item (iii)	Failed and insolvent	Temporary nationalization

(Measures for Orderly Resolution: for banks, bank holding companies, security firms, insurance companies, etc.)

Specified Measures Under Item (i)	Inadequate capital	Capital injection or liquidity provision
Specified Measures Under Item (ii)	Insolvent or failed (or when they are likely to become insolvent or fail)	Financial assistance

Under "The FSA's Approach to Introduce the TLAC Framework," Japanese G-SIBs' preferred resolution strategy is the Single Point of Entry (SPE) approach, in which resolution tools are applied to the ultimate holding company by a single resolution authority (applying Specified Measures Under Item (ii) to the ultimate holding company). In other words, in normal times, the ultimate holding company issues "TLAC-eligible instruments" (External TLAC) to meet the minimum External TLAC requirements and distributes the resources to the material subsidiaries in advance (Internal TLAC). In the event that a subsidiary is threatened with bankruptcy, the losses are absorbed by the ultimate holding company by writing off or converting into equity the Internal TLAC, etc. As a result, following the Specified Confirmation by the Prime Minister under the "Specified Measures Under Item (ii)," the ultimate holding company that absorbed the losses would be liquidated while the subsidiaries responsible for the main business operations would be transferred to a Specified Bridge Financial Institution established by the DICJ and continue their operations, receiving financial assistance if necessary.[3]

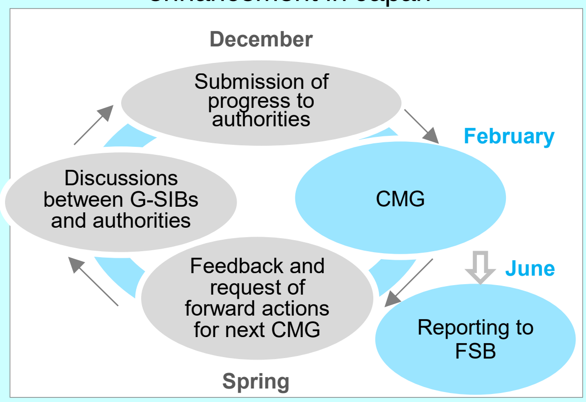
[Chart 4] Overview of SPE scheme



Progress toward resolvability in Japan

In order to ensure the effectiveness of the "orderly resolution," the relevant authorities in Japan and Japanese G-SIBs are cooperating and collaborating in line with the Key Attributes. Specifically, the CMGs for Japanese G-SIBs are held around February every year to report and discuss progress made since the previous meeting, and the results are reported to the FSB.[4]

[Chart 5] Annual cycle for resolvability enhancement in Japan



The topics discussed by the CMG so far include, for example, (1) continuity of critical functions after the commencement of resolution, (2) preparedness regarding TLAC requirements, (3) developing and improving recovery plans, and (4) liquidity management in resolution. In each topic, steady progress has been made every year and shared with the relevant host authorities.

In other words, with regard to (1), it is necessary to ensure the continuous access to the necessary services in order to continuously provide critical functions after commencement of the resolution process. For this purpose, it is important to confirm contracts with service providers such as financial market infrastructures of the payment, clearing and settlements, as well as other service providers such as financial data vendors to check if the services are continuously available, and make contractual adjustments as necessary. In this regard, Japanese G-SIBs have generally completed such confirmation and adjustments and are conducting annual reviews to see if there are any changes to financial market infrastructures and service providers. In addition, although the "stay" that was mentioned earlier has been legislated in Japan, Japanese G-SIBs are making contractual arrangements to ensure that the stay is effective even for contracts governed by foreign laws and have already completed such arrangements with most of their counterparties.

As for (2), all Japanese G-SIBs have already issued External TLAC instruments in excess of the required level on a group basis, and a large part of the resources from External TLAC has been distributed to material banking subsidiaries, etc. The authorities in Japan are receiving reports on the state of TLAC issuance and distribution from Japanese G-SIBs and contributing to international discussions on TLAC.

With regard to (3), the Japanese G-SIBs have already developed their recovery plans that include a governance framework for crisis management and recovery options. The effectiveness of the plans has also been confirmed through capital and liquidity stress tests. The recovery plans are reviewed on an annual basis and reflect lessons learned through recent developments; for example, the COVID-19 stress in March 2020.

Regarding (4), in 2017, the authorities in Japan requested that Japanese G-SIBs establish a management information system to report the information necessary to assess liquidity positions and needs in the event of resolution within 2.5 days. For example, such information includes the position of High-Quality Liquid Assets (HQLA) for each major currency and major subsidiary, as well as 60-day projection of cash inflows and outflows. All Japanese G-SIBs completed the system development by the spring of 2021. This system also contributes to an improved ability to respond to market shocks in normal times, for example, by enabling prompt liquidity risk assessment under market stress, such as the COVID-19 stress.

In addition to the topics above, the focus of international discussions in recent years has shifted to (5) the valuation capabilities in resolution and (6) the testing/drills to improve effectiveness of resolution playbooks. It can be assessed that, after the establishment of the "orderly resolution" schemes, G-SIBs first focused on developing their internal frameworks, such as improving governance and systems and confirming the status of contracts regarding operational continuity, but now the focus has shifted to more practical arrangements.

In response to these international discussions, regarding (5), the FSA is leading discussions on the capabilities required for Japanese G-SIBs to promptly assess their assets and liabilities (valuation capabilities) in the event of a crisis. With regard to (6), since Japanese G-SIBs have already prepared manuals and other documents in preparation for a crisis, they are required to conduct testing/drills using these documents and confirm their resolvability. In particular, given the time difference between Japan, Europe and the United States, it is highly significant to conduct testing/drills that incorporate overseas offices to ensure smooth communication with those offices at the time of resolution. Toward orderly resolution, the authorities in Japan have strived to develop public regimes and enhance preparedness of financial institutions. Going forward, it will be necessary to further address practical issues and enhance effectiveness of resolution regimes.

[Chart 6] Progress and status on each topic

Topics	Status
(1)Operational continuity	✓ completed confirmation of contracts to continue critical functions ✓ completed arrangements on stay with most counterparties
(2)TLAC	✓ issued sufficient External TLAC and allocated to material sub-groups
(3)Recovery planning	✓ plans are already prepared and reviewed annually
(4)Liquidity management	✓ developed system to report necessary information in 2.5 days

Topics	Status
(5)Valuation capabilities	✓ continuing discussions on prompt valuation methods during a crisis
(6)Testing/Drills	✓ updating manuals and planning practical testing/drills

Concluding Remarks

We have briefly reviewed the international and domestic progress to address the TBTF problem over the past decade, and it can be assessed that steady progress has been made toward resolvability, beginning with the establishment of public "orderly resolution" schemes, followed by the developments of internal frameworks in financial institutions, and then addressing the practical issues. That said, it should be noted that the journey has not ended. The subtitle of the 2021 Resolution Report from the FSB -- "Glass half-full or still half-empty?" -- summarizes the overall progress made over the past decade, including the resolution not only in G-SIBs but also in insurance companies and financial market infrastructures. Despite the progress, the glass is not yet full, even for G-SIBs that have made steady progress in this area.

In order to fill the remaining part of the glass, as mentioned above, the key issue will be how to identify and resolve specific practical issues. The TBTF problem cannot be solved only by improving the effectiveness of the resolution regimes; it is also important to effectively regulate and supervise financial institutions during normal times. It remains highly important for financial institutions to prepare for a crisis when the financial system is stable. For this reason, the authorities in Japan, in cooperation with Japanese G-SIBs and relevant host authorities, will continue to make steady progress on these initiatives.

[1] Every year, the FSB identifies G-SIBs based on the importance to the financial system. For details on assessment methodology, refer to the website of the Basel Committee (https://www.bis.org/bcbs/gsib/).

[2] The Bank of Japan may also provide liquidity to financial institutions as a "lender of last resort" in order to avoid the emergence of systemic risk. However, such liquidity provision is regarded as temporary and is not intended to compensate for losses incurred by financial institutions. The DICJ is responsible for providing financial assistance in the resolution process.

[3] For details, refer to the FSA's website (https://www.fsa.go.jp/en/news/2016/20160415-1.html).

[4] As of the release of this report, three Japanese financial institutions, Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group, and Mizuho Financial Group, are designated as G-SIBs by the FSA based on the assessment of the FSB. In addition, financial institutions that are not G-SIBs but for which particular need for a cross-border resolution arrangement exists and failure would have particular systemic significance for the Japanese financial system are subject to TLAC requirements in Japan, designated by the FSA; as of the release of this report, Nomura Holdings, Inc. falls under this category. In light of this significance, Nomura Holdings, Inc., as well as the three G-SIBs, are making steady progress and enhancement toward resolvability.

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