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Banking Crises and the Japanese Legal Framework

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Abstract

This paper presents an overview of the Japanese system to deal with the distress of banks, providing a classification of the regulation and remedies based on the level of systemic risk of the troubled entity. The paper differentiates between the types of actions available and analyses in detail the instruments and their application. While the regulation is disperse and its apprehension is complicated for a foreign reader, Japan counts on a modern, thorough and adequate group of institutions and instruments to tackle bank distress. Its most notable feature is the proportionality of measures and the flexibility enjoyed by a resolution authority that may accommodate its intervention to the characteristics of the case and the degree of contagion risk. Although mainly inspired by the American model, the system is compared with the new European framework and FSB recommendations are considered. Although a few elements could be reconsidered, its high institutional level and flexibility make the Japanese system one capable of dealing with financial crises at both national and international levels.

Keywords: Bank Resolution; Financial Crisis; Preventive Corrective Action; General Bankruptcy Proceedings; Systemic Risk
JEL classification: G21, G33, K23

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I. INTRODUCTION

This paper purports to provide a general and critical description of the legal and institutional framework to tackle the financial distress of banks in Japan. Although the regulation and the institutions involved are partially coincidental, the paper does not cover the financial distress of non-banking financial institutions.[1]

A. Methodology and Sources

The analysis has been conducted by a foreign academic specialized in international banking and insolvency law that is neither qualified to practice law in Japan not specialized in the intricacies of the local legal system, beyond –if at all– the specific topic of this paper. It offers, thus, an "external vision" to the system. This alien perspective explains the comparative approach of the analysis. The Japanese system is hereby observed against the benchmark of accepted international standards, as well as compared with international legal systems, with particular regard to those of the United States (seemingly Japan´s closest influence) and the European Union (the most complete and recent, and the author´s place of origin and expertise). The paper includes an assessment or, more precisely, some topics to be given further consideration by the local peers as a result of the said comparison and the best understanding by the author´s foreign eyes. The assessment has thus its limitations and ought to be read bearing all these circumstances in mind.

In order to conduct the research and write the paper, the author had access to the following resources: i) the laws and relevant subordinate legislation that compose the Japanese recovery and resolution system of banks,[2] as well as the relevant international texts; ii) the reports, official and disseminating documents, notices and reviews published in English by the Japanese authorities implied in the financial market (especially the Bank of Japan (hereinafter BOJ), the Institute of Monetary and Economic Studies, the Financial Services Agency of Japan (hereinafter FSA), and the Deposit Insurance Corporation of Japan (hereinafter DICJ) and its subsidiaries)[3]; iii) the reports of international financial institutions on the Japanese financial system (with special reference to those published by the International Monetary Fund (hereinafter IMF), the World

[1] Neither insurance companies, securities companies nor funds are covered in this paper. Moreover, there is no separate analysis of the specific problems posed by the insolvency of enterprise groups of banks. The analysis will be applicable *muatis mutandis*, to holding banks and its subsidiaries, but individually considered.

[2] The author accessed the unofficial translation of the relevant laws available at, www.japaneselawtranslation.go.jp. Some of the regulations were not available in English. In these cases, the author accessed their content with the kind help provided by staff of the Bank of Japan, who either directly translated them or confirmed the adequacy of the information found in research papers and institutional reports and websites.

[3] See, https://www.boj.or.jp/en/; http://www.imes.boj.or.jp/english/index.html; http://www.fsa.go.jp/en/; and www.dic.go.jp/english/.

Bank and the Bank of International Settlements (hereinafter BIS)); iv) the academic and official articles published in English on the Japanese financial system, included in the bibliography at the end of this paper; and v) many hours of interviews and discussions with the most kind, patient and learned staff of the BOJ, the DICJ and private sector professionals.

The paper is structured as follows: first, a brief historical introduction is provided with the exclusive aim of explaining the evolution and contextualizing the current legal system; the bank recovery and resolution system is divided into a *preventive part*, that is analyzed in the first place, and a *reactive part*, which composes the bulk of the system: the institutional and legal frameworks are defined, after which the different instruments and restructuring measures are considered, ordered in accordance with the types of financial institution, or, more precisely, based on their potential to externalize the institution´s own failure on to the rest of the financial sector, the market and the economy in general. Once the recovery and resolution system has been fully explained, a brief section provides the basic numbers on the implementation of the system, and briefly describes the three most recent and relevant cases. One last section provides a general assessment and a number of topics for further reflection.

B. Context and Evolution of the System

1. The beginning

For decades after the war, Japan´s financial sector was contained and stable. No major bank insolvencies happened.[4] The banking sector operated under a model that was labeled the "convoy system," according to which the Ministry of Finance (hereinafter MOF) and the BOJ closely monitored the functioning of the financial sector and ensured the solvency of the institutions. With a view to serve a country in reconstruction after the Second World War, the system was allegedly construed more as a joint venture of public and private institutions tasked with the intermediation between savings (depositors) and the industrial sector, than as a competitive, essentially private financial sector where banks look to maximize their own profit. One bank or another, depositors had no reason to distinguish. The stable growth of the Japanese economy preserved the system for decades. A liberalization of the banking sector started in the 1970s, and, in line with the new situation, a Deposit Insurance system was established (1971).

2. The Reform Years

Initially, the protection offered to depositors by the DICJ was limited to 1 million yen. It was not until 1986 when the model started to develop, including the still existing methods of "insurance payout" and "financial assistance" as well as enhancing the protection of deposits to an amount of

[4] A thorough and most informative analysis of the early years of Japan´s financial crises in the late 20th century, with the perspective of an insider, can be read in Nakaso [2001]. See, also, Hoshi and Kashyap [2000].

10 million yen. Even after the overhaul in the mid-eighties, the deposit insurance fund was too small and unprepared to offer protection to depositors beyond a small financial institution.[5] In the late 1980s, the Japanese economy went through a period of over-heating and the prices of the stock exchange and the real estate rose to unprecedented levels. This asset price bubble rapidly affected the financial sector, whose stability was for the first time in decades in jeopardy. The first time funds were loaned by the DICJ to a failed financial institution was in 1991 (Toho Sogo Bank), when the bubble had stared to burst. It was still confined to a number of minor institutions, far from any systemic impact. In December 1994, two small credit cooperatives defaulted (Tokyo Kyowa Credit Union and Anzen Credit Union). More real trouble did not begin until the summer of 1995, when a series of bank failures hit the country: Cosmo Credit Union fell in July, and Kizu Credit Union and Hyogo Bank followed in August.

At this point, a wider crisis of non-performing loans (NPLs) that threatened the stability of the Japanese financial sector in the 1990s, affecting mortgage financial institutions with particular intensity, was fully underway. The Deposit Insurance Act (hereinafter DIA)[6] was substantially amended in 1996: to prevent panic in depositors, full protection of bank deposits was established in 1996 [7]; authorities were provided with more flexibility and financial assistance tools to tackle the default of financial institutions; and mandatory insurance *premia* contributions were raised to 0.084% of insured deposits, since, at that time, the deposit insurance fund was grossly under-resourced (and, by the end of the fiscal year 1996, the fund had been exhausted).[8] Already early in 1997, NPLs had become a salient problem even for the larger financial entities. In that year, the Nippon Credit Bank and the Hokkaido Takushoku Bank became insolvent (although the latter only after a failed merger). The same fate was suffered by Sanyo Securities, Yamaichi Securities and Tokuyo City Bank. November of 1997 turned into a “black November” for Japan´s financial market.

In February of 1998, the legislator took a big step. The passing of the Act on Emergency Measures for Financial Functions Stabilization (hereinafter Financial Function Stabilization Act) [9] constituted a milestone for the recovery of the system. A large amount of public funds were injected into the financial sector,[10] and the Financial Crisis Management Committee was created.

[5] Nakaso [2001] pp. 2 et seq.

[6] Act No. 34 of April 1, 1971 (amended).

[7] The main problem affected the “Jusen”, non-bank financial corporations often owned by banks that provided housing loans, and that were very active during the period of the real estate bubble. In order to specifically address this problem, in 1996 “the Act on Special Measures to Promote the Resolution of Assets and Liabilities of Jusen Companies” was passed.

[8] DICJ [2016] p. 169. In this initial period, at its peak, the Deposit Insurance Fund had 876 billion yen, only 0.158% of the value of the insured deposits at that time: see, Koo and Sasaki [2010] p. 7.

[9] Act No.5 of February 18, 1998 (abolished by the Financial Revitalization Act (*infra* note 44)).

[10] According to Watanabe [2011] p. 37, 1.8 trillion yen were injected into 21 banks, mostly through subordinated debt. Other sources (Nakaso [2001] p. 11) increases the amount of public funds made available to 30 trillion yen; 17 trillion assigned to a special account of the DICJ.

Another measure was a revaluation of land, that sought to improve the position of banks by the regulatory treatment of unrealized mortgage claims as tier 2 capital. Notwithstanding these efforts, the Long-Term Credit Bank of Japan, an internationally active credit institution, failed. It was soon evident that the measures had been insufficient, and, in October 1998, two laws were passed: the Act on Emergency Measures for the Revitalization of Financial Functions (hereinafter Financial Revitalization Act),[11] and the Act on Emergency Measures for Early Strengthening of Financial Functions (hereinafter Early Strengthening Act)[12]. The Financial Revitalization Act was used for the nationalization and restructuring of the Long-Term Credit Bank of Japan and the Nippon Credit Bank. Based on the Early Strengthening Act, available public funds went from 30 trillion to 60 trillion yen. In March 1999, 7.5 trillion yen were used to recapitalize 14 large banks, as well as the Bank of Yokohama, the largest regional bank.

Both laws were emergency laws, with a predetermined expected term of validity of 5 years. The DIA was revised in 2000 to make those frameworks permanent. In one of the most important reforms of the system, the DIA introduced rules to streamline business transfers, allowed for financial assistance in case of partial business transfers, enhanced the powers of the financial administrator, improved the regime of functioning of bridge banks, added the measures of capital injections to assuming institutions, and added operations of loans to help failed institutions repay insured deposits. In April 2002, full protection of deposits was ended. Protection was then re-set at 10 million yen.

3. The latest update of the system following the international global crisis

In the mid-2000, a financial crisis that originated in the US financial and real estate sectors grew rapidly through unregulated securitization and massive trading of derivatives, devastated the American financial markets and rapidly spread to the European financial and sovereign sectors. In the wake of these arguably unprecedented financial disasters, countries around the world understood that trouble in one place may almost immediately cause uncontainable damage elsewhere, and that hence regulatory standardization, enhanced control and strong coordination were required. At the end of 2011, the Financial Stability Board approved the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (hereinafter "the Key Attributes"). The core of the Key Attributes was to provide minimum standards that every country ought to follow as well as to address the problem posed by systemic, too big to fail, cross-border institution.

Following its endorsement by the G20, the highest instances of Japan´s Government convened a task force of experts, labeled "Working Group on Framework of Regulations on Banks which Contribute to the Stability of the Financial System," to address the issue internally. In January

[11] Act No. 132 of October 16, 1998.

[12] Act No. 143 of October 22, 1998.

2012, the Working Group made public a report that served as the grounds for the 2013 reform of the Japanese financial system.[13]

The system in place before the 2013 reform was locally centered, conceived to address Japan´s paradigmatic case for distress (the increase in NPLs) and to stave off the risk of contagion through the usual contagion channels in cases of bank failure (bank runs, cross-financing, lack of trust in the inter-bank market etc.). The reform introduced a new approach to the crisis management framework, one that enhanced supervision, the sharing of information at international level and increased the battery of responses to address the risk that general market distress spread to the entire system through the financial markets.[14]

In the following sections, a thorough description of the Japanese system to control and resolve bank crises is provided. It purports to offer a complete picture, and therefore it includes all parts of the system: from those measures and institutions whose action is aimed at avoiding banking crises (preventive action), to the reactive crisis management framework.

II. THE SYSTEM OF PREVENTIVE ACTION

The distress of financial institutions has a high potential to cause damage much beyond those directly involved with the troubled debtor. Given the direct interrelation between financial institutions, their indirect linkage through the non-financial economy and the difficulty to contain the rapid spread of mistrust by users of the system, Governments need to set up preventive barriers to minimize the risk of banking failure.[15] In this sector of the economy, prevention is always better than cure. In line with the most complete systems, Japan counts on a dense array of instruments to detect and avoid the financial distress of its financial entities.

The system of prevention has three levels: two analytical levels, which concern both general and specific information, and a reactive set of instruments when an imbalance is identified. Although in Japan the key institutional player is the FSA, the preventive leg of the system relies heavily on a wider institutional setting.

[13] For the content of the Report, see, FSA [2013].

[14] For a description of the 2013 reform, see, Kodachi [2013] p. 14.

[15] While the assertions in the text are generally true, they are more so in countries where the relative size of the financial sector with regard to the general economy is large, and where the direct linkages between the public sector and financial sector are close and intense. Japan meets both of those requirements (specially the latter). As of March 2016, Japan had 116 banks (5 city banks, 4 trust banks, 105 regional banks and 2 other types), 267 Shinkin banks, 155 credit associations, 679 agricultural associations, etc. (see, Japanese Bankers Association [2016]).

A. The Analytical Level of Prevention: General Supervision of the Banking Sector

The first level of analysis is the competence of the BOJ. It is based on the periodic generation, reception and analysis of general relevant information. It consists of a "macro-prudential" outlook on a wide range of factors that are relevant to the risk level of the financial sector, over a given period of time.[16] It is based on the idea that most sectors of the economy are one way or another connected with banking risk; and that currently it is necessary to be wary of both domestic and international markets. This part includes information on macro-risk indicators as well as information on stress testing from a macro-perspective.[17] Three types of indicators are used: the Financial Activity Index (FAIX),[18] which is the early warning system for identification of financial imbalances; the "Financial Cycle Indexes," that seeks to identify instability in the financial system and changes of tendency; and the "Systemic Risk Indicators," that measures the contribution of financial institutions to systemic risk. The macro-prudential perspective includes also a sectorial analysis of the financial markets and all supervised participants. Aggregated –comparative– data on the risk profile of financial institutions (size and growth of loan portfolios, risk distribution, etc.) and the general data on capital and liquidity bases are provided.

The second layer of the system of preventive control corresponds with the supervision of the financial institutions. Japan counts on a highly sophisticated supervisory framework, in full compliance with international regulatory standards.[19] Its design conforms a state-of-the-art system, valid for the efficient surveillance, inspection and evaluation of financial institutions. It is articulated through the FSA´s internal institutional framework and its array of competences, complemented by the cross-information and the –limited– supervising activity of the BOJ. The system differentiates between the *inspection* and the *supervision* functions. The differentiation is only for organizational and functional purposes, since both activities – and the institutions competent to implement them – are meant to be in constant cooperation and dialogue.[20]

[16] The main elements of the macro-prudential outlook are published periodically in a lengthy, detailed document labelled *Financial System Report,* issued by the BOJ and freely accessible in English (available at https://www.boj.or.jp/en/research/brp/fsr/index.htm/).

[17] The stress testing tries to capture the relationship between the financial system and the non-financial economy, including simulations of how negative economic shocks affect financial stability. For details on this, see, BOJ [2015]. The first macro-approach stress testing took place in 2011-2012 as part of the IMF´s Financial Sector Assessment Program (FSAP). That first assessment, as well as the ones conducted in the Financial System Report, showed a strong position of the Japanese financial sector.

[18] The FAIX was introduced in 2012. It includes 14 indices that reflect the situation of Japan´s financial activity. By comparing the value in a given moment with its historical trend, the supervisor is in a position to identify symptoms of overheating or overcooling of financial activity. In light of this, both monetary policy and supervision may be adapted to the situation. It is noteworthy that the system of indices includes different sectors of activity, making it a highly apt instrument to identify problems outside the ordinary system of financial supervision. For a recent revision of the validity of the system, see, Ito *et al.*[2014].

[19] See, IMF´s FSAP Update 2012, IMF [2012] p. 21.

[20] The approach of the FSA was given a modernized twist to deal with the new challenges post-Lehman in 2013. A number of reforms, and, specially, a publicly announced new approach to the FSA´s activity took

The Inspection Bureau, which includes a Planning and Evaluation Division and an Inspection Coordination Division, has different offices in charge of risk management and information analyses, and conducts both on site and off site inspection duties. According to the most recent approach, with a view to enhance efficiency and to save costs (both of the banks and of the FSA), the main bulk of the activity is conducted off site. The content of inspections and supervision is made public and clearly spelt out in the highly relevant "Inspection Manual for Deposit-Taking Institutions" (hereinafter Inspection Manual), an extremely detailed treatise of bank inspection, and in the "Comprehensive Guidelines for Supervision of Major Banks, etc." (hereinafter The FSA Supervisory Guideline).[21] Supervision includes a coordination division, with specific offices depending on the types and characteristics of the markets. In line with the needs of the Japanese banking sector, highly fragmented, the Supervisory bureau has separate divisions for the monitoring of the major banks and the regional and tier 2 regional banks. There is continuous collection of relevant information from financial institutions, both concerning their main figures and their operations, which are constantly under detailed scrutiny. The supervision, though, is facilitated by an imposed policy of self-responsibility and disclosure, expected from all banks in Japan.

In addition to the foregoing, the Japanese system would seem to count on a potentially powerful mechanism to identify problem banks. The Inspection Manual makes it compulsory for banks to test their capital and liquidity adequacy against their own, bespoke stress scenarios frequently, and to report the results, the information about the methodology and the type of contingencies contemplated as often as every quarter.[22] Although the Inspection Manual is a guide for FSA

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place in the slipstream of the Financial Stability Board´s renovated "activism" on systemic banking risks in the international arena. The FSA conducts nowwhat has been labelled as "Dynamic Supervision": According to this approach, stiff regulatory requirements, as those strengthened after the 2008 global crisis, provide a "wall" that might not be enough to provide a fully effective prevention of banking crisis. And this would be so, not because the walls are not thick enough, but rather because their static nature creates conflicts and influences behaviors in a way that may weaken financial stability. The FSA´s approach prefers to supervise the system by observing a moving –dynamic– picture, that brings into consideration all the relevant stakeholders. In particular, the following needs to be closely monitored: the relationship between the risk taken, the returns earned and the capital retained by banks; the relationship between the bank, the capital market, and the real economy; and, last but not least, the business model and the relationship between the bank and its customers. The current strategy of Japan´s FSA was clearly summarised in a relevant speech of its Commissioner, Mr. Nobuchika Mori in ISDA´s 31st Annual Conference in Tokyo, 13 April 2016 (see, Mori [2016]).

[21] Although the FSA Guidelines are available only in Japanese, the Inspection Manual is available in English (http://www.fsa.go.jp/en/laws_regulations/).

[22] As part of the measurement of comprehensive risk with the use of the internal model approach, the Manual (pp. 349, 350) asks the inspector if the financial institution complies with the rule that "[…] *Stress testing is performed on the comprehensive risk measurement model a least on a weekly basis. The financial institution has established the framework for reporting to the FSA the overview of results of the stress testing on a quarterly basis (in a timely manner when such results show a lack of required capital for the comprehensive risk).*"

These rules would place Japan in line with the most recent reforms adopted in the European Union. The periodic control through bespoke stress tests has been included as part of the European Banking Authority´s inspectors, not a direct rule to the supervised institutions, there is a common understanding that its prescriptions are mandatory.[23] We have not been able to ascertain the degree of granularity of the tests and the degree of implementation of the rule, especially in the case of the local and regional banks.

The third layer consists of a reactive mechanism, which allows the Supervisor to act whenever certain situations are identified. The system has been labeled Prompt Corrective Action (hereinafter PCA).[24] The assignment of this type of reactive tool in the hands of the Supervisor allows for a coherent and efficient system of identification and treatment of the problems. Supervision (with its different activities of surveillance, inspection or evaluation) and the early warning system are instruments to identify the situations of weakness (or potential weakness) of financial institutions, and, as such, constitute the instrument or *ex ante* mechanism to trigger the PCA. In the following paragraphs we shall describe in some detail this preventive, reactive instrument.

B. The Reactive Instrument: The Prompt Corrective Action system

In June 1998, the Early Strengthening Act was passed. The law amended the Banking Act[25] to include the creation of the PCA programme, which was effectively implemented in March 1998 for internationally active banks, and in March 1999 for purely domestic institutions.[26] In essence, the PCA is a mechanism of automatic reaction when banks become financially "weak." The

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"Guidelines for Triggers for the Use of Early Intervention Measures," approved pursuant to the mandate of art. 27 (4) of the Bank Recovery and Resolution Directive 59/2014, and, especially, the "Guidelines on Common Procedures and Methodologies for the Supervisory Review and Evaluation Process (SREP)," available at https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+(Guidelines+on+SREP+methodologies+and+processes).pdf. Although there are differences concerning the scope, the periodicity of the tests is very similar.

The adequate application of stress-testing methods in Japan is no surprise. The country made its financial institutions go through a series of stress tests as early as in the late 90s. The BOJ, alongside the MOF, examined all the major banks in early 1999 trying to identify any capital shortfalls under distressed scenarios. Whenever an institution was found to require more robust capital buffers, it was recapitalizes using public funds. See, Harada *et al*. [2015] p. 55.

[23] However, the fact that the rules that prescribe obligations are not directly aimed at those that must comply with them, but rather at the controller of their implementation, must bear legal consequences. Banks would not seem to be obliged to conduct the stress-tests because the Inspection Manual so states, but because the inspectors, exercising the power of representation of the FSA, so dictate; and it is binding based on the general powers of supervision of the FSA, which are evidently binding on the supervised banks. In other words: it would not seem possible to sanction a non-compliant bank, or to obtain a court order determining the obligation of the act to comply, based on the Inspection Manual, but only based on their legal duties towards the supervisor. The source of the norm that grounds the coercion is different.

[24] *See*, *supra* note 28 and its accompanying text.

[25] The Banking Act (Act No.59 of June 1, 1981, amended).

[26] The capital ratio was for the first time formally introduced in Japan as the main supervision criterion/trigger.

“weakness” is directly linked with the capital ratio of the financial institution.[27] The FSA is tasked with devising and controlling the implementation of the actions, which will vary in kind and intensity depending on the degree of capital loss. The system takes into consideration risk-weighted capital ratios.[28] On the face of it, the PCA is an early action instrument because it is designed to trigger remedial measures before –balance sheet– insolvency. This instrument, if properly implemented,[29] should contribute greatly to ensure action takes place before default, although capital ratios are far from being an adequate measure to prevent an event that depends more often on liquidity tensions.[30]

The legal basis for the PCA are to be found –although only generally– in Art. 26 of the Banking Act. Paragraph 2 of the said article refers to an Ordinance (subordinate legislation) [31] that contains the bulk of the regulation. The rule differentiates between internationally active and purely domestic banks: the capital requirements of the latter are half those of the former. The triggers are determined with regard to Common Equity Tier 1 capital, Tier 1 capital and Total Capital ratio, and the types of capital are defined as in Basel III.[32] Similarly –but not equally– to the American FDIC´s model,[33] the PCA includes five categories of risk-based capitalization levels (See, Table 1):

[27] The Japanese PCA resembles very closely the American early action system introduced by the 1991 amendment to the Federal Deposit Insurance Act. The resemblance is complete concerning the capital ratios (for internationally active banks), and very high regarding the measures to be adopted. Japan adopted exactly the same name as its US counterpart.

[28] The use of risk-weighted capital ratio was introduced in 1998 with the Early Strengthening Act. The rule constituted a very important amendment in the regulatory framework of Japan´s financial sector. In this regard, see, Watanabe [2011] pp. 39 and 40.

[29] Banks must at least report their capital ratios on a semi-annual basis, see, Art. 19 of the Banking Act.

[30] For a general analysis of early-trigger measures and what went wrong in the Resona Bank and Ashikaga Bank cases in Japan, see, Chan-Lau and Sy [2015] pp. 12 *et seq*. An analysis on the efficacy of the PCA in the US, and its detection failures in the recent US financial crisis, see, United States Government Accountability Office [2011].

[31] “Order Providing for the Categories, etc. Prescribed in Article 26, Paragraph (2) of the Banking Act.”

[32] See, BIS, “Basel III Definitions of Capital” (available at, http://www.bis.org/publ/bcbs204.htm).

[33] The US system (s. 38 of the FDIA) creates the following categories, considering risk-based capital and leverage ratios: “Well Capitalized” (total capital 10% or more, Tier 1 of 6% or more, 5% or more leverage); “Adequately Capitalized” (total capital of 8% or more, Tier 1 of 4% or more, 4% leverage, or 3 % if bank is 1 rated and not growing); “Undercapitalized” (total capital of less than 8%, Tier 1 of less than 4%, less than 4% leverage, or of 3 % if bank is 1 rated and not growing); “Significantly Undercapitalized” (total capital of less than 6%, Tier 1 of less than 3%, less than 3% leverage); and “Critically Undercapitalized” (below ratios above, tangible equity to total assets ratio of 2% or less).

Table 1 Categories of Risk Based Capitalization Levels

Categories \ Capital Ratio	Total Capital Ratio	Tier 1 Capital Ratio	Common Equity Tier 1 Ratio
No action	8% or more	6% or more	4.5% or more
Category Ⅰ	8%-4%	6%-3%	4.5%-2.25%
Category Ⅱ Type 1	4%-2%	3%-1.5%	2.25%-1.13%
Category Ⅱ Type 2	2%-0%	1.5%-0%	1.13%-0%
Category Ⅲ	Negative	Negative	Negative

As stated above, the percentages for banks purely active in the Japanese domestic market are halved.[34] Domestic banks, hence, must have lower capital levels to trigger early action by the FSA. The PCA for the different categories is as follows:

a) *Category I* (TC 8-4/4-2): The FSA will issue an order to the financial institution requesting the drafting of an improvement plan that ensures the viability of the entity, as well as its adequate and efficient implementation. There are no further rules as to the content of the plan, which is hence subject to the discretion of the supervisor. [35]

b) *Category II Type 1* (TC 4-2/2-1): If the capital is eroded to the level captured by this category, the financial institution will not only have to draw and implement a plan to strengthen capital levels, but may be subject to the following measures: i) an order to restrain the payment of dividends to equity holders and/or bonus and special retributions to the management; ii) to reduce the total number of assets or restrain the increase of the number of assets; iii) to limit or to restrict taking deposits under conditions which are found to provide disadvantages compared to strict ordinary market conditions; iv) to reduce the volume of business activity, including the closure of places of activity, with the exception of the main centre of business, and/or to limit the type of activities that the institution is authorized to undertake in accordance with articles 10 and 11 of the Banking Act. Further to the said possible lines of action, the Ordinance empowers the FSA to dictate any other measure that it is considered necessary to prevent the default of the institution.

c) *Category II Type 2* (TC 2-0/1-0): If the institution finds itself in this category, the possible lines of action are four: i) boosting capital to *acceptable* levels; ii) a severe contraction of the business; iii) a sale or a merger of the business; or iv) to terminate the business. It is the FSA that shall choose the measure and order its implementation.

[34] In accordance with the Order Providing for the Categories under Art. 26(2) of the Banking Act (*supra* note 31), domestic banks are those which have business operations only in Japan, as opposed to international banks, which have also "overseas business operations". Currently, Japan counts on 16 international banks and 100 domestic banks. See, Japanese Bankers Association [2016].

[35] The plan would normally include measures to beef up the capital of the institution. In this line, see Watanabe [2011] p. 40.

d) *Category III*: when the capital has fallen below zero (i.e., balance sheet insolvency), an order will be issued to suspend, totally or partially, the business activity of the institution.[36]

The PCA is an instrument of supervision, and its mere existence should send a message of reassurance to the markets, but it contains no automatic triggers. The FSA may adopt the measures included in the Banking Act and its Ordinances, *but it is neither automatic nor compulsory* that the supervisor takes those measures. The FSA has discretion as to whether measures are to be adopted as well as to what the said measures will consist of.

Outside the strict scope of the PCA, the Japanese system of supervision and early detection of weak financial institutions may –and, allegedly, does– take in due consideration to other highly relevant measures. The most important ones would be the following (applicable for all banks alike, unlike the capital requirements of the PCA): (i) of particular relevance –since it is directly linked with the inability to satisfy claims as they fall due, which is the main factual trigger for bank resolution measures– is the Liquidity Coverage Ratio Rule (LCR) [37]; (ii) the Leverage Ratio Rule, that has been expressly adopted by the FSA Commissioner in its Notification concerning Consolidated and Non-Consolidated Leverage Ratio Rule [38]; or the Large Exposure Rule,

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[36] A comparison between the Japanese and the American PCAs shows that the American counterpart to the FSA has the possibility –*rectius*, the mandate– to act considerably earlier. In the US, even banks with capital ratios between 8 and 10% are subject to restrictions as to the type of deposits they may deal with; "undercapitalized" institutions (capital between 8 and 6%) must also file a recovery plan, cannot pay dividends or certain type of extraordinary management fees, their asset growth is restricted and prior approval is required for acquisitions, branching and the opening of new lines of business; banks with a total capital lower than 6% are treated as "significantly" undercapitalized and are subject to undertake strict action to recapitalize (sale of shares/bonds or to attempt a merger), operations with affiliates are restricted, as are the interest rates paid, further restrictions to the remuneration policy of the senior executives are applicable, intervention in the management is possible, and growth and business activities limited, to mention only some possibilities; and in the case of "critically undercapitalized" institutions, after 60 days payment of capital and interests of subordinated debt is to be withheld, and within 90 days the relevant Authority is to appoint a receiver or take any other action that seems necessary to minimize losses to the Deposit Insurance Fund.

[37] The FSA Supervisory Guidelines sets a number of rules concerning liquidity ratios. So, for example, it requires a bank to establish an internal framework to appropriately control liquidity risk, to maintain control mechanisms as well as internal reporting procedures subject to the approval of the board, and instructs financial entities to generally be alert for possible liquidity shortages. See, FSA Supervisory Guidelines (*supra* note 21) III-2-3-4.

Compliance with the set ratios is directly contemplated in the "FSA Commissioner Notification Concerning LCR Rule as a Criterion to be used by Banks to Determine the Soundness of their Management under Article 14-2 of the Banking Act" (in force since March 2015).

Although no doubt positive for the adequate detection of troubled banks, the LCR might generate negative incentives to the Japanese financial sector. The LCR might push banks to acquire more Japanese Government debt, a most liquid investment, increasing the already enormous portfolio of public bonds in the balance sheets of banks (especially of regional banks). This risk has been expressly recognized by the Japanese regulatory authorities: see, Morita [2013] slide 28.

[38] Its official title is "FSA Commissioner Notification Concerning Consolidated and Non-consolidated Leverage Ratio Rule Set Forth in Art.1(1)(v) and (vi) of the FSA Commissioner Notification about Adequacy of Equity Capital according to Art.19-2(1)(v)(4) of the Order for Enforcement of the Banking Act."

prescribed in Art. 4(7) and (8) of Order for Enforcement of the Banking Act (derived from Art. 13(1) of the Banking Act).

In any case, it has been alleged that the supervisory authority (FSA) derives an open –generally unrestricted– power to order measures needed for the adequate supervision of entities from the general declaration included in Art. 21 of the Banking Act, entitled "Disclosure of Explanatory Documents on the Status of Business and Property for Public Inspection, etc." [39]

In the previous sections we have seen that Japan´s macro and micro supervisory systems, coupled with the PCA, provide a robust framework for the early identification of problem and weak financial institutions. However, failures in the implementation, temptations to apply excessive regulatory forbearance,[40] insufficient or imperfect information by the supervised institutions [41] or simply unpredictable, external factors of many sorts (economic, political or even natural disasters) may cause failures to arise. In the following sections we shall analyze Japan´s main reactive mechanisms to deal with bank distress. First, the institutional and legal frameworks will be briefly introduced; then, a more thorough description of the bank recovery and resolution system will be provided.

III. THE FRAMEWORK TO TACKLE BANKING CRISES

As it was briefly described in the historical note to the introduction of this paper, the Japanese financial sector has been shaken several times in a relatively recent period. As the crises happened, new institutions were created or amended, and new laws were passed. Moments of crisis and

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[39] Because of its possible effect as a general empowering rule for the FSA, its literal transcription would seem justified: "[…] *A bank shall, for each business year prepare explanatory documents that contain matters specified by the cabinet office ordinance as those related to the status of its business and property for the interim business year and such explanatory documents for the entire business year, and keep them at its business offices* […]". This article is complemented with the very wide list of topics to be developed by FSA Commissioner Notification about Adequacy of Equity Capital according to Art. 19-2(1)(v)(4) of the Order for Enforcement of the Banking Act: outline of the business and its organization; content of the main business; financial condition in the previous 2 years; amount of NPLs; matters related to the adequacy of equity capital; matters related to liquidity; etc.

[40] The active promotion of policies of soft treatment of debtors by the supervisor has taken place in Japan in the past, especially concerning small and medium enterprises. In the wake of the economic crisis caused by the Great East Japan Earthquake of 2011, financial lenders were encouraged to actively reschedule loans and try to seek agreed solutions to corporate distress. The practice of almost automatically grant additional time for repayment without a rigorous analysis of the restructuring plan –which some have regarded as risky and bordering institutional "ever-greening", see Peek and Rosengren [2003] – may constitute a risk factor in Japan. Even from the perspective of the recovery of loans by the DICJ (*rectius*, from the Resolution and Collection Corporation –RCC– a fully owned subsidiary of the Corporation), the soft treatment of debtors seems to be an almost institutional mandate (see, the general explanation of the RCC activity, RCC [2015]). For a criticism of the regulatory treatment of SME loans, see, Harada *et al.* [2015] p. 62.

[41] Off balance sheet liabilities can be an example of unforeseen losses. Japan has examples of it: for example, the insolvency of Yamaichi Securities in 1997 (see, Koo and Sasaki [2010] p. 8).

urgency are never good times to implement legal reforms (in Japan or anywhere), since the specific contours of the particular urgency tend to bear excessive influence in the shape of the reform, leaving the country with rules that are not always apt for a permanent framework. In a few years since the late 1990s, Japan approved an "Act on Special Measures concerning Promotion of Disposal of Claims and Debts of Specific Jusen Companies," [42] the Financial Functions Stabilization Act,[43] the Financial Revitalization Act,[44] the Early Strengthening Act,[45] an "Act on Special Measures for Promotion of Organizational Restructuring of Financial Institutions, etc.," [46] an "Act on Special Measures for Strengthening Financial Functions" [47]; and amended several times the DIA, only to mention some cases. Most of the said laws –and their subordinate legislation– are no longer in force, but some still are. This paper will focus its analysis on what can be regarded as the basic, permanent legal and institutional framework for the recovery and resolution of banks [48] and the prevention of financial crises. Special, time-constrained, norms will only marginally be considered.

A. The Legal Framework

The system to confront the crisis of deposit taking institutions is mainly regulated in the DIA, amended several times, with special relevance for our purposes in 2000 and 2013. To obtain the full legal framework, the DIA needs to be completed with the provisions of the Banking Act and its related subordinate legislation and insolvency laws. The regulation of the PCA is also part of the framework, since it not only sets the thresholds to trigger early action, but also determines the measures to be adopted.

The different situations and the choice menu of solutions that emanate from the said legal framework are not easily organized in a systematic manner. Taxonomies of legal instruments to tackle corporate business crises tend to be based either on the possible exits (reorganization vs liquidation), on the implication of courts (out of court workouts vs formal insolvency proceedings) or according to the financial situation of the debtor (financial distress, cash flow insolvency, balance sheet insolvency). However, none of those would help very much in the case of the Japanese framework to confront banking crises. Disparate exits are possible for different types of debtor as well as for diverse financial situations; and the institutional framework is

[42] Act No.93 of June 21,1996.

[43] See, *supra* note 9.

[44] See, *supra* note 11 .

[45] See, *supra* note 12

[46] Act No.190 of December 18, 2002 (hereinafter Organizational Restructuring Act).

[47] Act No.93 of June 21, 2004.

[48] Unless otherwise expressly stated, reference to "banks" is to be understood generally as insured "Financial Institutions", in the meaning provided in Art. 2 (1) of the DIA.

essentially one for all cases.[49] There exists no chapter where the general aspects –i.e., common to all cases of bank distress– are addressed. This makes the interpreter´s work difficult at times.

Furthermore, the DIA refers to the general insolvency laws for some aspects of the resolution of insolvent banks. General insolvency law serves, thus, as a complement to the bank recovery and resolution system, either to complement the effects desired on the bank or its creditors, or to wind up and allocate the remainders in the cases of entities that will cease to exist after the process. The interpreter will need to refer to the regulation of the *Civil Rehabilitation* [50] (which was used by, for example, Lehman Brothers Japan, or for the case of the Incubator Bank), of the *Corporate Reorganization* [51] (used for insurance companies), or of the *Bankruptcy Liquidation* [52] (the main proceedings where failed institutions end, following a transfer of the business: for example, the cases of Yamaichi or of Sanyo) [53]. In 1996, the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions (hereinafter Act on Special Treatment) [54] was passed. The Law tries to complete and adapt the general corporate insolvency proceedings to the special circumstances of financial institutions.[55]

In reality, the recovery and resolution system of Japan is *essentially based on the repercussion of the institution´s failure*. A different degree of repercussion receives different legal treatment. This approach is consistent with the main reason that makes bank insolvencies special, different to the insolvency of most businesses: their ability to externalize the damage to non-related

[49] Probably the reason for this legal complexity lies in the fact that the Japanese legislator has chosen the Law that regulates the deposit insurance system to provide a full framework for all cases of bank distress. The law takes the DICJ as the focal point of the regulation (when it is only part of the system), and, further, the current state of the Law is the result of different amendments over the years. There is no international standard as to the best legal technique to regulate bank insolvency. There seems to be a wide consensus that special laws are better suited than added chapters to the general insolvency laws, but there seems to be no widespread preference for a standalone law or a regulation that is inserted within the major financial laws of the country.

[50] Civil Rehabilitation Act (Act No. 225 of December 22, 1999, amended. Hereinafter "CRA").

[51] Corporate Reorganization Act (Act No. 154 of December 12, 2002, amended).

[52] Bankruptcy Act (Act No. 75 of June 2, 2004, amended).

[53] The interpreter may want to complete the framework with the dissolution and liquidation process included in the Japanese Companies Act (Arts. 476, 929 and 475-509, 510), available at, http://www.japaneselawtranslation.go.jp/law/detail/?printID=&id=2035&re=&vm=02. In some cases, these entities have been extinguished following these proceedings (e.g., the case of the Incubator Bank, see, press release of the Incubator Bank as of 10 September 2012, available at, http://www.shinkobank.co.jp/info/pdf/press120910.pdf.). This would only be possible, naturally, when the entity was no longer insolvent (i.e., after all the debt had been restructured, or because the financial entity had enough to pay all of its creditors). The procedure included in the Companies Act is a standard corporate law procedure aimed at the termination of the "life" of a solvent corporation, where –by definition– all creditors have been paid before any allocation of proceeds is made to shareholders. In its application to banks, this corporate mechanism must have been used when there were no creditors left and with no distribution of a liquidation dividend to shareholders, unless all creditors had been paid in full.

[54] Act No. 95 of June 21, 1996, amended (see *infra* note 55).

[55] Corresponding to the amendments of the general corporate insolvency framework after 1996, the Act on Special Treatment itself has been amended on a number of occasions: the last time by the Act No. 91 of June 27, 2014.

stakeholders and, ultimately, to the wider market. If there is no risk of contagion, or of widespread damage to persons that have not been directly involved in the activity of the failed institution, then general insolvency law should do the trick, with a few *ad hoc* rules. We could therefore divide the regulation in: a) situations in which the failure of the bank generates no external risk (*simple bank crises*); b) situations in which the absence of special measures may endanger the ordinary flow of credit or damage consumers in the region or field of the entity (*enhanced non-systemic bank crises*); c) situations of financial crisis, where special measures are required to maintain an orderly credit system in Japan or in a region of Japan (*locally systemic institutions crises*); and d) those cases where action is required to avoid severe disruption in the financial markets of Japan or other places (*internationally systemic institutions crises*). We shall analyze each in turn. The classification is provided mainly for taxonomic reasons to facilitate the understanding of the system. But the main tenet of the Japanese system, underlying and informing the classification when necessary, is the great degree of flexibility in the hands of the banking authorities. Almost in most cases, the relevant authority may flexibly choose one solution or another, depending on the specific characteristics of the case.

Another element that needs to be clarified is the relationship between the level of financial distress and the different remedies envisaged in the Japanese system. As it will be described later in this paper, the remedies and acts to be implemented in a given case are linked with the degree of deterioration of the financial situation of the bank, so there is a highly relevant practical meaning to the definitions. Similarly to other frameworks that deal with banking crises, the use of the classic corporate insolvency law concepts does not strictly apply. Most of the references to failure or insolvency are directly –and, it seems, exclusively– made to events related to the repayment of deposits (and deposit-derived obligations). The DIA uses two concepts: "failed financial institution," and "insolvency." Often, both concepts are used together, by referring to "failed or insolvent" institutions. The Act includes a definition of "failed financial institution" in Art. 2(4): "*a Financial Institution that has suspended repayment of deposits, etc.* [56] *(meaning the performance of obligations pertaining to deposits, etc.* […]*) or is likely to suspend repayment of deposits, etc., in light of the status of its business or property*." The definition would seem to constitute a "partial" cash flow insolvency: the test will be met when the most senior of debts (deposits) cannot be paid or the bank will not be in a position to pay them in the near future given its distress.[57] The reference to "*the status of the business or its property*" is an undefined expression, which would seem to encompass a situation of poorly functioning business model, a business that is unlikely to generate sufficient revenues (for whatever reason, even external), or a

[56] The expression "Deposits, etc." is also defined in Art. 2(2) of DIA, as "*(i) deposits; (ii) installment savings; (iii) installment deposits prescribed in Article 2, paragraph (4) of the Banking Act* [i.e., deposits accepted within a designated fixed period of time on the promise of payment of a fixed amount of money on or before the end of that period]; *(iv) money received under contracts pertaining to money trusts (including loan trusts) for compensation for a loss of principal* […]*; (v) money received through the issuance of Long Term Credit Bank Bonds* […]" and other similar type of bonds.

[57] See, *infra* note 208 and its accompanying text.

situation in which the assets are either insufficient in value or excessively illiquid. In other words, the test is extremely wide and open.

The possible problem lies with the direct link between the test and one particular type of debt (namely, the debt owed to depositors). Although, as stated above, this is explained by the main bulk of the system being regulated in the DIA (which is naturally concerned with actions to be undertaken by the DICJ, whose primary task is linked with deposits), it would seem to leave some uncertainty as to the relationship between non-compliance with other debts and obligations and the triggers to tackle bank distress and the resolution mechanisms. Would a bank that is unable to satisfy a bond issuance in a given date (or that will likely find itself in such situation in the near future) be a "failed bank" in the sense of the law? The problem would be all but non-existent in those cases where PCA actions are at the disposal of the supervisor; but the problem is that the PCA is linked with shortages of capital, not with liquidity problems (at least not directly).[58]

The Act also contains a definition of "insolvency": Art. 69-4 considers "insolvency" as "*the condition in which the said Financial Institution, due to the lack of ability to pay, is generally and continuously unable to pay its debts as they become due* […]" Apart from its circularity, the said article does contain a classic definition of cash flow insolvency, and it does not only refer to deposits. However, this definition is not helpful, since it cannot be given general interpretative meaning. It is the state the financial institution must be at if the rules of Art. 69-4 are to be applied, and the rules concern only settlement obligations and rights of set off.[59]

In practical terms, however, the problem is arguably more apparent than real. Financial institutions whose distress would constitute some sort of risk beyond that inherent to the damage of the stakeholders directly involved may be subject to a number of measures, since their failure or insolvency is not a requirement for action. On the face of it, the problem could apply to the financial entities that do not pose an external risk to the market or to the credit flow or consumers, i.e., the smallest institutions. In those cases, however, the problem could be solved by the direct application of the general insolvency law proceedings (Civil Rehabilitation, Corporate Reorganization or Bankruptcy proceedings), whose commencement could be understood to trigger some of the measures envisaged in the DIA. Moreover, these laws would not impede the

[58] See, *supra* note 37.

[59] Conspicuously, not even Art. 74, which regulates the displacement of the debtor and its control by a receiver, a classic insolvency measure, provides a general definition of insolvency. In order for the receiver to be appointed, apart from a number of additional requirements (some degree of systemic risk, etc.), the financial institution must be "*unable to satisfy its obligation in full with its assets, or that, in light of the status of its business or assets,* [it] *is likely to suspend repayment of Deposits…*" Just like the definition of "failed financial institution."

It is worthy of mention that, in the Japanese version of the DIA, the expression "Shiharai funo" is used to refer to "insolvency" in Art. 69-4. Although the translated version of DIA uses the term of "insolvency" in many cases, including Art. 69-4, referring to different situations, the Japanese version of the DIA is more accurate, using three different expressions; "Saimu choka", meaning "balance sheet insolvency"; "Shiharai teishi", meaning a suspension of repayments; and "Shiharai funo", meaning the inability to pay debts due (closer to a "cash flow" insolvency).

protection of depositors by the DICJ, that would surrogate itself in the position of the creditors to the extent of the coverage of the insurance.

B. The Institutional Framework

Before setting out to describe the different cases and their regulation, it would seem necessary to make express reference to the institutional setting tasked with the implementation of the system.

The implementation of the system is in the hands of a number of public and semi-public Authorities and institutions. For the sake of clarity, a division shall be drawn between those competent to adopt the main decisions and those whose role has a predominantly technical component.

The majority of decisions are attributed ultimately to the Prime Minister of Japan.[60] The Prime Minister shall have the decision to sell the shares of the troubled entity, to have the DICJ provide it with new capital, to issue an injunction order appointing a receiver or to adopt any of the legal measures necessary to avoid the collapse of a systemically important financial entity, only to mention some examples. Most of the decisions are to be adopted jointly by the Prime Minister and the Minister of Finance (and the Minister of Health, Labour and Welfare or the Minister of Economy and Trade, depending on the type of institution). Consequently, even for technical matters, much of the deciding power –and responsibility– rests on the Prime Minister. This is no surprise, given the high level of discretion awarded to the Authorities and the ample powers envisaged in the Japanese system of recovery and resolution. When the decisions concern institutions whose crisis may have systemic effects, their adoption is made by the Prime Minister following deliberation at the Financial Crisis Response Council (hereinafter FCRC). The FCRC is a consulting body created ad hoc to ensure a collegiate and coordinated decision-making process in matters of policy and high risks, such as large-scale failures of financial institutions or contagion to relevant areas of the economy.[61] It is composed of the Prime Minister (Chair of the Council), the Chief Cabinet Secretary, the Minister of State of Financial Services, the Commissioner of the FSA, the Minister of Finance and the Governor of the BOJ.[62]

The technical component of the institutional setting rests on the FSA and the DICJ. These two institutions play the leading role in the design and implementation of the system. The relationship

[60] The DIA states that, subject to a few exceptions, the Prime Minister´s authority under the Act will be delegated on the Commissioner of the FSA (Art. 139(1) of the DIA). It is noteworthy, though, that the exceptions where the Prime Minister´s authority may not be delegated are of high importance. By way of example, they include the triggers for action in case of crisis of locally or global systemic financial institutions (Arts. 102(1) and 126-2 (1) of the DIA).

[61] The FCRC is also competent to promote the implementation of the measures adopted within the Council. An example of the way the FCRC operates can be found in the insolvency of the Ashikaga Bank, whose course of action was decided, through the deliberation of the Council, in November 29, 2003. See, DICJ's site (http://www.dic.go.jp/english/e_katsudo/e_hatanshori/).

[62] See, Art. 42 of the Act for Establishment of the Cabinet Office (Act No.89 of July 16, 1999, amended).

between the two institutions is neither horizontal (the two are not at the same level) nor purely vertical (they have different competences), although it would seem accurate to state that the DICJ is mainly tasked with the implementation of the decisions taken by the FSA.

The FSA was created in 1998,[63] as a supervisor, separate from the MOF, from whom some of the new institution´s competences were detached. Although strictly speaking an independent supervisor, it constitutes a part of Japan´s public administration and its decisions are subject to administrative law. The FSA´s contribution to the system to deal with the financial crisis of banks covers all of its stages: the FSA is mainly responsible for the early detection of the bank´s distress, through its general and *ad hoc* supervisory and surveillance mandate; the Agency adopts the most relevant decisions within the early action framework (from controlling the recovery plans to deciding on more direct measures); it is the driving force behind the design of the strategy to tackle the capital shortage/liquidity problems or the failure of an institution; and the FSA is also tasked with the monitoring of the entire process of implementation of the recovery or resolution plans, to be conducted by the DICJ and other entities. *The FSA is, thus, the key player of the system*.

The DICJ was established in 1971,[64] when Japan moved to a deposit insurance system similar to the Federal Deposit Insurance Corporation of the USA. Its role has grown substantially in importance through the years, to become the most relevant implementing institution during and after the financial crisis of the 1990s.[65] The DICJ would seem to have a mixed, public-private legal nature. Regulated by law and subordinate legislation, the Government of Japan holds direct competences in its establishment, and in the appointment, removal and supervision of senior officers.[66] The members of DICJ's policy board are deemed public officers for penal purposes.[67] Its funds are, however, collected through insurance *premia* from –mostly private– financial sector institutions,[68] it has the capacity to borrow in the markets and acts in the market using private law (most of its operations are subject to contract or the Companies Act, to mention some examples) .[69] Which courts will decide litigation against the actions of the DICJ will depend on

[63] In 1998, the FSA was created as an external administrative body of the Prime Minister´s Office, independent from the MOF (that had conducted the supervision of financial institutions until that moment). It was in July 2000 when, following a reorganization of the service, it was named FSA, as it is called now. An overview of the FSA can be read here: http://www.fsa.go.jp/en/about/pamphlet.pdf.

[64] Following a report issued by the Financial System Research Committee of July 1970, the DIA was passed in March 1971, creating the Deposit Insurance Corporation of Japan. Its initial capital was subscribed in equal parts by the Japanese Government (150 million yen), the BOJ (150 million yen) and by private financial institutions (150 million yen).

[65] See, Nakaso [2001], *passim.*

[66] Arts. 11, 26, 29 of the DIA.

[67] Art. 23 of the DIA.

[68] Art. 50 of the DIA.

[69] Art. 42 of the DIA.

the nature of the action that is subject to challenge: in case of "public acts," the action will have to be started before administrative law, and before ordinary civil courts in the rest of cases.

As stated earlier, the DICJ plays the main role in the implementation of the system. Its mandate is mostly focused on the performance of insurance operations (collection of *premia*, payment of insured deposits), but it goes well beyond to become the executive arm of the resolution system: among other functions, the DICJ provides financial assistance,[70] finances mergers and generally corporate rescue operations, provides surveillance of failed institutions, or acts as trustee/receiver in insolvency cases involving entities that take part in the insurance system. The DICJ performs its duties directly, through other public or private institutions by way of –authorized– delegation, or by controlled entities of its group. Specially relevant for the bank resolution system are the five bridge banks created by the DICJ,[71] or the Resolution and Collection Corporation (hereinafter RCC), a subsidiary created in 1998 to assist in the collection and management of NPLs. The relevance of the RCC in the resolution operations when the bank´s financial distress comes from a depreciation of assets and an increase level of NPLs cannot be overestimated.

IV. MECHANISMS FOR THE RECOVERY AND RESOLUTION OF BANKS IN JAPAN

Having examined the applicable legal framework and the principal elements of the institutional framework tasked with its implementation, the following paragraphs will cover the main bulk of this paper: an orderly description of the different measures and instruments to tackle the financial distress of weak and insolvent banks. In line with the more modern tendencies, reference will be made to the system of recovery (early stage measures, no extinction of the financial institution) and resolution (different degrees of financial trouble and disparate exits to the situation of banks, including –but not limited to– the extinction of the entity). As stated above, the best way to provide a description without excessive overlaps is by the type of financial institution and its relationship with the financial market (i.e., its ability to externalize the risk on to the market).

A. Mechanisms to confront simple banks crises

As stated above, the Japanese framework foresees different groups of measures to tackle the distress of financial institutions. The whole package is presided over by the principle of flexibility, allowing the relevant authorities to graduate the "firepower" of their actions depending on the needs of the case. The measures increase in intensity as does the risk inherent to the crisis of the affected financial institution. Hence, there is express regulation for locally systemic institutions (Arts. 59 *et seq*. of the DIA, see section B); an enhanced battery of actions to tackle the financial crisis of larger, national institutions (Art. 102 of the DIA, see section C); and, finally, a most

[70] See, Part IV. B.1., especially, *infra* note 109 and its accompanying text.

[71] See, *infra* note 119 and its accompanying text.

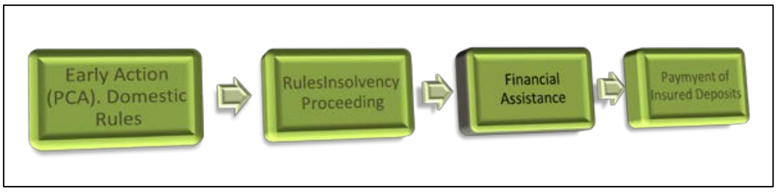
powerful range of actions when globally systemic institutions are under threat (Art. 126 of the DIA, see section D).

In line with this incremental approach, the legal framework pays little attention to the financial distress of banks that are so small or their activity so encapsulated that they pose no external risk, beyond the damage to all the usual stakeholders involved in the failure of a business (creditors, shareholders, employees, tax authorities, etc.). There *are no special, ad hoc rules in the banking or financial regulation for these cases*. And this might make sense, since, in the absence of a systemic risk, general insolvency remedies might be enough to solve the crisis. On the face of is, this would mean that the interpreter has to look to the general insolvency proceedings, since these rules are bound to play a bigger role than in the insolvency of larger entities (generally insolvency proceedings with the special rules envisaged for the distress of banks, insurance companies and investment funds, regulated in the Act on Special Treatment).[72]

But the fact that there are no express rules for this type of –small– entities *does not mean that the bank recovery and resolution system is not applicable to these cases*. As we will see below, under certain circumstances, the provision of financial assistance (as is generally the case for the larger entities: see section B below) and, the preventive regulatory system may also be applicable to the distress of the smaller entities. At the same time, the DICJ may decide there is no need for its use of these measure and the general insolvency law would be the stand–alone solution. The reason why the system of non-systemic bank insolvencies is explained here separately is not because of the difference in the applicability of theregulation but rather because the factual differences of the case may entail the implementation of a different solution in practice.

Graphically, the framework for the smaller entities would be composed of the following (see Figure 1).

Figure 1 Chart for the Basic Scheme



Firstly, the smaller entities are also covered by the early action mechanisms: both by supervision (as adapted to this type of entities),[73] and by the PCA. Naturally, the capital ratio thresholds of the PCA will be those applicable to domestic entities (from 4% down to negative capital). Similarly to larger entities, banks in this category *may* have been required to present a viability plan, to beef

[72] See, *supra* note 55 and its accompanying text.

[73] As described in the "Comprehensive Guidelines for Supervision of Small-and Medium-Sized Enterprises and Regional Financial Institutions," for example.

up capital ratios, to amend the management system, to reduce activity and assets, or to close part or all of the business. [74]

If none of the preventive measures worked (or they failed to be applied), such a small bank would not need to resort to the general insolvency system as a stand alone solution. In accordance with Art. 74 of the DIA, the Prime Minister (i.e., the FSA) may issue an injunction ordering the management of the business and the property of the entity to be placed under the management of a financial administrator. The appointment of the financial administrator will happen in case the bank´s liabilities are greater than its assets, or if, in light of the status of the business or assets, the institution is likely to default –or, *a fortiori,* already has defaulted– upon the repayment of deposits.[75] Further, and although the appointment of the financial administrator is generally a remedy for banks with a certain degree of systemic risk, the Act also leaves its use open in case "*(i) the operation of said Financial Institution´s business is extremely inappropriate.*" [76] In light of the foregoing, the more "usual" bank resolution mechanisms (thoroughly described in the following section) may be applied –instead of only ordinary insolvency proceedings– whenever there is a default or a risk of future default of the deposits, or in cases of gross mismanagement.[77] The existence of the requirements and the need for the regulatory solutions may be discretionally appreciated by the relevant banking authorities.

In case general insolvency is the way forward for these cases, there are three possible insolvency proceedings [78]: Civil Rehabilitation, Corporate Reorganization and Bankruptcy (liquidation).[79] On the face of it, it is unclear which of the three is more suitable for small deposit-taking institutions. Both Civil Rehabilitation and Corporate Reorganization are aimed at the continuation of the business through a restructuring plan, although they have been used in the past to liquidate entities. Among the two, experience shows that Civil Rehabilitation proceedings are preferred for banks, while Corporate Reorganization proceedings have been chosen to deal with the insolvency of insurance companies. Perhaps the main difference between both types of proceedings lies with the effects on the debtor: while in the Corporate Reorganization cases the management is displaced and a receiver appointed, in Civil Rehabilitation cases the debtor will normally continue to run the business, and the appointment of a receiver is only a possibility.[80] This could be a plausible explanation in cases where there is some level of external risk, since the

[74] Order Providing for the Categories, etc.. Prescribed in Article 26(2) of the Banking Act.

[75] Art. 74(1) of the DIA.

[76] Art. 74(1)(i) of the DIA.

[77] Art. 74 (1) also allows for the appointment of a financial administrator in case of systemic risk, although this requirement would not be applicable to this section (which regulates only the smaller Banks).

[78] The following reflections would also be applicable, mutatis mutandis, to the financial distress of larger entities (section B below).

[79] The FSA may petition for the opening of any of the three types of proceedings, as established by the Act on Special Treatment, Arts 377, 446 and 490.

[80] This has been alleged as the main cause for the use of Civil Rehabilitation for the insolvency of deposit taking institutions: see, Sakai [2012] p. 4.

FSA has resorted to the appointment of a financial administrator (e.g., the DICJ) to run the proceedings, and therefore there would seem to be no reason to proceed to a second appointment, that could only add unnecessary complexity and costs (the appointment of a financial administrator is done ex Art. 74 of the DIA, and the administrator cannot be regarded as a receiver appointed under the general insolvency proceedings automatically). Another –more likely reason– concerns the procedural design of both proceedings. While the Civil Rehabilitation provides for a rather flexible framework, with plenty of room for the parties to maneuver and the Court to ponder and balance the interests at stake, the Corporate Reorganization is a more rigid –and to a certain extent classic– court procedure.[81] The necessary intervention of public agencies and the likely participation of large numbers of creditors would seem to make flexibility advisable. On the other hand, the use of bankruptcy (liquidation) may be the most quick and efficient solution if the business has been stopped or transferred during the PCA.[82]

If it has not happened earlier, the opening of Civil Rehabilitation proceedings will bring along a stay of actions, executions and payments of pre-commencement claims,[83] and, as a consequence, the reimbursement of deposits will be suspended. This would entail the occurrence of a "Category One Insurable Contingency," which is the trigger for the protection of deposits in the Japanese system.[84] Hence, the selected insolvency procedure will be developed in parallel with the mechanics of the deposit insurance system.

These are the main elements of involvement of the DICJ and interaction with the court procedure.

Firstly, the Japanese system of protection of deposits is generous. It includes full coverage of "deposits for payment and settlement purposes" (i.e., deposits payable on demand, bearing no interest and apt to provide payment and obligation settlement services),[85] and up to 10 million

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[81] An element that might prove problematic concerns the court competent to decide the proceedings. In cases of small, non-systemic banks, it may well be the case that the activity is purely local. Following common standards, the rules to determine the court competent (for example, Art. 5 of the CRA) use the main place of business as basic criterion. With the exception of group cases where the parent company is also insolvent, or for entities with more than 1,000 creditors, where the courts of Osaka or Tokyo would be also competent, it would seem likely that the case develops in a court with limited expertise in complex insolvency files.

[82] It has been argued that one of the reasons is the possible lack of an efficient decision making process and an overlap of functions between trustees appointed in case of Corporate Reorganization proceedings and financial administrators (in cases where they are appointed under the banking regulatory framework). Another reason alleged is that, under Civil Rehabilitation, the rights of secured creditors would be more protected than under the alternative proceedings and, therefore, this solution would has less impact on financial market. See, Endo *et al*. [2012] pp.54-59.

[83] Arts. 85 and 39 of the CRA.

[84] Art. 49(2)(i) of the DIA.

[85] Art. 54-2 of the DIA.

yen of "general deposits," [86] in both cases per person, per institution. These limits mean that there is a need to determine who the depositors are and for which amount. Financial institutions are supposed to have adopted a number of measures to ensure a streamlined determination of the depositors,[87] but the main work falls on the shoulders of the DICJ. The DICJ will receive from the bank the data of the depositors, which will then be aggregated and ordered by name.[88]

Secondly, the list will be separated between insured and non-insured deposits. Insured deposits will be fully paid by the DICJ, and, consequently, will not participate in the Civil Rehabilitation proceedings (or any other type of insolvency proceedings that has been commenced). The DICJ will surrogate itself in the place of the insured depositors. [89]

Thirdly, the moment, form and place of the payment of insured deposits will be determined by the Policy Board of the DICJ, depending on the facts of the case.[90] The main circumstances of the payment will be made public and advertised in the Gazette and other publications. The payment may take place as cash payment or by means of a substitute transfer of the deposit to a third institution.[91]

Finally, the DICJ collaborates with the Civil Rehabilitation and other insolvency proceedings acting as agent of depositors that are not insured (and hence become creditors in the general insolvency proceedings) for the sake of notifications, or by submitting an organized and complete list of depositors to the Court on the final day of the period for creditors to file their claims (period immediately before which, an initial list had been made publicly available for consultation).[92]

It is worthy of note that, in this type of situation, the DICJ is not appointed as a financial administrator and, on the face of it, would seem to have no legal power to adopt or promote any of the actions envisaged in the DIA for the resolution of failed institutions. If this was correct, a

[86] Art. 54 of the DIA. "General deposits" are deposits, for principal and interest, that do not fall within one of the following categories: i) foreign currency deposits; ii) negotiable certificate of deposits; iii) publicly offered bank deposits and bank debentures whose custody arrangement has expired; iv) certain loan trusts whose rights of beneficiary are recorded in the transfer of corporate bonds, shares or other securities; v) deposits in special international financial transaction accounts; vi) deposits from the BOJ; or vii) deposits from insured financial institutions and the DICJ. See, Art. 51 of the DIA.

[87] Following Art. 58(3) of the DIA, financial institutions are supposed to: i) have an action protocol in place to quickly identify and separate, for each client, insured and non-insured deposits; ii) set up a framework that allows for the quick and precise separation of changes to deposits that happened before and after the commencement of rehabilitation proceedings etc. ; and iii) count on a manual or similar internal document to streamline the offsetting of deposits and loans and estimated proceeds payment of uninsured deposits. See, DICJ [2016] p. 26.

[88] Art. 55-2 of the DIA.

[89] Art. 58 of the DIA.

[90] Art. 57 of the DIA.

[91] Since the repayment of deposits is not immediate, and with a view to minimize the damage to depositors, the system allows anticipated payments of up to 600,000 yen per account (of principal). The anticipated payments would happen within a week from the contingency, and decision if and how to make these payments is the competence of the Policy Board of the DICJ. See, Art.56(3) of the DIA.

[92] See, Arts. 459-463 of the Act on Special Treatment.

merger, a transfer of valuable assets to a bridge bank and other operations would have to be decided within the context of the Civil Rehabilitation plan and in accordance with the CRA. The DICJ´s powers and duties would hence be confined to collaboration with the Court and to act in the defense of depositors in the formal in-court proceedings.[93] However, the scope of the DICJ´s powers is so confined only in case no express appointment of a financial administrator is made. It could be argued that the opening of general insolvency proceedings –in any of its forms– brings about some sort of stay of payments (and therefore of deposits). This would entail that the triggers for "financial assistance" as regulated in Arts. 59 et seq of the DIA would be met, [94] and that the DICJ would hold the powers described in more detail in the following section. The same would happen in case the FSA deemed the bank to be in a situation of likely –future– default on the payment of deposits. These powers would be strengthened by the general insolvency framework.[95]

B. Enhanced Non-Systemic Bank Crises

This section covers the distress of banks with some potential to generate harmful externalities. Using the expression from the DIA, it would concern situations in which the absence of special measures "*is likely to cause considerable detriment to the smooth supply and demand of funds and convenience of consumers in the region or fields in which the said Failed Financial Institution conducts its business.*"[96] Although the expression is open and somehow cryptic, it would seem to refer to the insolvency of an institution that may endanger the ordinary flow of credit or damage consumers in the region or field of activity of the entity, but which may not cause a financial crisis of any kind. In other words, the focus of the danger is on the local economy, not on the rest of the financial sector.

In reality, this low-intensity external risk constitutes the entry gate to the vast majority of the possible measures envisaged in the legal framework to tackle bank distress. With some exceptional measures reserved for risks of severe financial contagion and for the larger entities (see, Part IV.C. and D.), the entire fire-power of the bank recovery and resolution system can be unleashed in this case.

The possibilities to act in case of distress of this kind of banks will first depend on its financial condition. In a nutshell, there are three types of measures: (i) a group of possible actions labelled

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[93] This would be consistent with the mandate of the DICJ, which is limited to the protection of the interest of depositors (and similar claims): See. Arts. 466 and 467 of the Act on Special Treatment.

[94] See, Art. 49(2)(i) of the DIA.

[95] It could be argued that the FSA´s main line of action concerning the insolvency of the smaller banks would be to opt –via financial assistance mechanisms– for a takeover by another financial institution. This would be in line with the Government´s approach to a financial sector that might seem overly fragmented. The reduction of the number of smaller banks would then be achieved through the resolution mechanisms.

[96] Art. 74 (1)(ii) of the DIA. The same expression is used to authorise the main operations of financial assistance (Art. 61(3)(iii)) and to appoint a financial administrator (Art. 74), both of the DIA.

as "financial assistance" by the DIA (Arts. 59 et seq); (ii) the replacement of the management by a financial administrator (Arts. 74 et seq.); and (iii) the opening of one of the types of general insolvency proceedings.

The "financial assistance" consists of a number of measures and restructuring schemes undertaken by the DICJ in the context of its activity as deposit insurer. Because of this, the measures would seem to be subject to an "insurance contingency" having taken place. The two types of "contingencies" are the suspension of the repayment of deposits (labeled "Category One Insurance Contingency") and the removal of the license to operate or the declaration of bankruptcy or dissolution (labeled "Category Two Insurance Contingency").[97] This means that the direct, initial use of the "financial assistance" method would take place when the financial condition is so eroded that deposits have ceased to be paid, or through the PCA the business has been shut down and the license removed.[98] Both are very extreme situations, most possibly too late to rescue any kind of value out of the on-going operation of the financial institution and to avoid the systemic risk of its failure. In light of this, before the financial assistance method is chosen, the bank ought to have been put either under the management of the financial administrator, or in insolvency proceedings, or, perhaps more effectively, under both.[99]

The financial entry gate to the issuance of an order assigning the management of the bank to a financial administrator is " *that a Financial Institution is unable to satisfy its obligations in full with its assets, or that, in light of the status of its business or assets, a Financial Institution is likely to suspend repayment of deposits* [...]." [100] The order may be issued before repayment of deposits has taken place, which would allow for early action and hence for an increased chance to preserve value. Furthermore, the *criteria* to open Civil Rehabilitation proceedings is " *When there is the risk that a fact constituting the grounds for commencement of bankruptcy proceedings would occur to a debtor,* [...]. *The same shall apply when a debtor is unable to pay his/her debts that are due without causing significant hindrance to the continuation of his/her business*".[101] Again, Civil Rehabilitation proceedings may be opened at an early stage, when there is a risk of

[97] See, Art. 49(2) (i) and (ii) of the DIA.

[98] The reading of the DIA does not expressly state that financial assistance is linked with the triggers of article 49, but this has been the interpretation of the DICJ itself. In this regard, it is worth quoting literally DCIJ [2015] pp. 8-9: *"If a Category One Insurance Contingency has occurred, the insured deposits are protected by either of the following two methods: the insurance payout method, whereby payouts are made to depositors; and the financial assistance method, whereby financial assistance is provided to an assuming financial institution or other entity* […]*."* It is noteworthy that both solutions would not seem to be applicable in case of Category Two Insurance Contingency. This is explained because when these circumstances have accrued (Category Two Insurance Contingency), the financial activity of the bank will not be maintained, and hence the institution will be liquidated and the depositors paid through the insurance payout method.

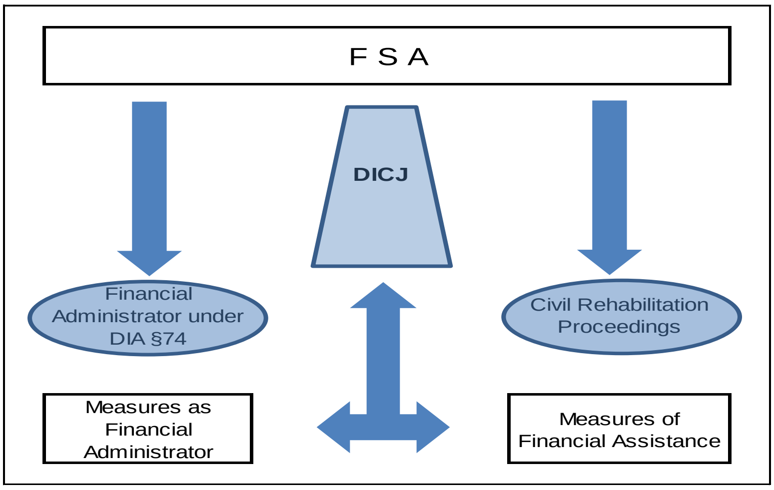
[99] In the case of the resolution of the Incubator Bank, the choice was made after the appointment of the financial administrator: see Endo *et al*. [2013] p. 107.

[100] See, Art. 74(1) of the DIA.

[101] See, Art. 21(1) of the CRA.

default but it does not need to have happened. The risk of further deterioration and value destruction is deemed sufficient. The appointment of a financial administrator opens up a range of possible actions in accordance to the DIA; and the commencement of Civil Rehabilitation proceedings triggers action for financial assistance.[102] In summary, unless the bank is already in state of default, the FSA should start proceedings under Art. 74 of the DIA and/or under the CRA before the DICJ decides on the measures to be adopted under the financial assistance framework. The measures and their time frame can be graphically expressed in Figure 2.[103]

Figure 2 Chart of the Possible Courses of Action



Although an order to appoint a financial administrator and/or the opening of Civil Rehabilitation proceedings would precede or be simultaneous to financial assistance measures, the latter constitute the main course of action and hence they shall be described in the first place.

1. Financial Assistance

In case of distress of a financial institution, and unless a Category Two Insurable Contingency has occurred and the continuation of the activity is not a possibility, the provision of financial assistance is the preferred bank recovery and resolution system by the relevant Japanese authorities.[104] It is a method according to which the DICJ provides financial assistance to an "*assuming financial institution*" that will assume the repayment of the deposits and compliance with the obligations of the troubled bank or to an entity that will itself finance the assuming institution. The financial assistance may take different shapes and help execute disparate forms of corporate and business restructuring operations. The operations may be undertaken directly,

[102] See, *supra* note 95 and its accompanying text. There are 182 cases that DICJ implemented financial assistance. See, DICJ [2016] pp.31, 32.

[103] The decision on what actions to take is the competence of the Policy Board of the DICJ.

[104] With a view to allow for the continuation of the activity and to minimize the losses and disruption to the market and the financial sector, the Financial System Council has expressly asserted its preference for this method over the insurance payout method to depositors. See, for example, DICJ [2016] p. 9.

when the assuming and contributing financial institution(s) are found in a brief period of time, or indirectly, through a bridge bank, when the assuming institution needs to be found and the deal negotiated over a period of time. The following are the main characteristics of the financial assistance method.

a. The financial situation of the distressed bank and the parallel use of other remedies

The bank may be in a situation of suspension of payment of deposits (Art. 49(2)(i) of the DIA), but, arguably, in most cases this will already be too late. A literal interpretation of Art. 59 (which includes the core regulation of the financial assistance) only refers to the involvement of a "failed financial institution" in the procedure for the financial assistance; and Art. 2(4) defines the concept of "failed financial institution" as that in which the institution has suspended *or is likely* to suspend payment in light of the situation of its business or property. Further, experience has proven that the financial assistance method is used together with the petition –by the FSA– for the appointment of a financial administrator in accordance with Art. 74 of the DIA. As stated above, the trigger for the appointment of a financial administrator is set at a moment previous to default, and according to Art. 74(3), "*A financial institution* [...] *that has become subject to the Injunction Ordering Management* [...] *shall be deemed to be a Failed Financial Institution*." Therefore there is no need to have defaulted upon the repayment of deposits and the chances of finding one or more institutions willing to take over the business are greater.

b. The institutional framework

A number of institutions are involved in the machinery of the financial assistance method. Firstly, a formal petition for financial assistance has to come from the participating institutions: either just the assuming financial institution, the assuming and the failed financial institution in certain cases of merger, or the financial institution that participates in the scheme by lending or supporting the operation. The petition is to be received by the DICJ, whose Policy Board will decide whether to provide the financial assistance and under which terms it is provided (or alternatively, to reject it and opt for the insurance payout method). The assistance will be requested to facilitate a specific operation, which will need a *previous* approval by the Prime Minister.[105] Since, as stated above, the FSA will have moved to remove the previous management of the bank, the financial administrator will be in charge of leading the implementation of the operation. Often –although not necessarily [106]– the financial administrator appointed will be the DICJ itself, especially in the

[105] Art. 61 of the DIA. See, DICJ [2016] p.9. In order for the Prime Minister to issue the authorization, the following conditions must be met: 1) the operation has to protect the interest of depositors and other creditors; 2) the financial assistance by the DICJ is necessary to conduct the operation; and 3) unless the operation takes place, the supply and demand of credit and the interest of consumers may suffer a detriment. These competences are delegated to the FSA Commissioner (Art.139(1) of the DIA)

[106] See, Art. 77 of the DIA. The system of appointment of Financial Administrators was introduced by the amendment of the DIA in 2000. The financial administrator would be chosen among experience and highly qualified lawyers, certified accountants/auditors and practitioners active in the financial sector. Until the

most complex cases. From the moment of the formal appointment, the administrator enjoys the most extensive powers of management and administration (Art. 77 of the DIA).

c. *The operations to be financed*

The DIA regulates in detail the type of operations that can be conducted.[107] The Act calls all operations under the label "merger, etc.", although, technically speaking, only some of them are mergers.[108] The array of possible operations includes all the classic M&A, corporate and insolvency law transactions (see, Figure 3 below). In short, the financial assistance can be provided to support: (i) a *"merger"* (either one in which the Assuming Financial Institution (hereinafter AFI) survives the operation – absorption type – or one in which both the AFI and the Failed Financial Institution (hereinafter FFI) disappear and merge into a newly constituted entity); (ii) *a "split"* (either one in which a part of the assets and liabilities are segregated from the FFI and assigned to one or more AFI (s) –absorption type of split –, or one in which a new entity is incorporated and will continue the business following the transfer of the relevant assets and liabilities from the FFI); (iii) a "business transfer" (either the FFI transfers all or part of its business and the corresponding liabilities –deposits– to an AFI, or there is a transfer of the insured deposits, or one or more AFI (s) acquire the shares of the FFI; in this last case, the assumption of the shares would be a requirement to take over and implement the business restructuring operations that have been agreed with the MOF and the Prime Minister).

d. *The type and limit of the assistance*

The DIA lists the type of financial assistance that the DICJ may provide to support the operations described in the previous section. The assistance may consist of (i) a grant of money (i.e., non-repayable funds); (ii) a loan or a deposit of funds; (iii) the purchase of assets; (iv) the guarantee or the direct assumption of obligations/debts; (v) a capital increase (e.g., subscription of preferred shares); and (vi) "securing of damage" (i.e., loss sharing agreement).[109] The decision on the type of financial assistance corresponds to the Policy Board of the DICJ,[110] that will take into consideration its own resources at the relevant moment and the maximization of its use, the expected cost of the assistance and the expected costs of the payment of the insurance given the

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moment of termination of this paper, the appointment of the DICJ had happened 12 times (DICJ [2015] p. 12), corresponding 8 to cases involving banks and 4 concerning credit unions.

[107] The list of possible operations that can be supported by the financial assistance method of the DICJ is wide, and includes all the classic corporate restructuring operations as well as more bank insolvency-specific types of transfers. The literal reading of Arts. 59(2), 59-2 and 60 would seem to indicate an exhaustive list of operations.

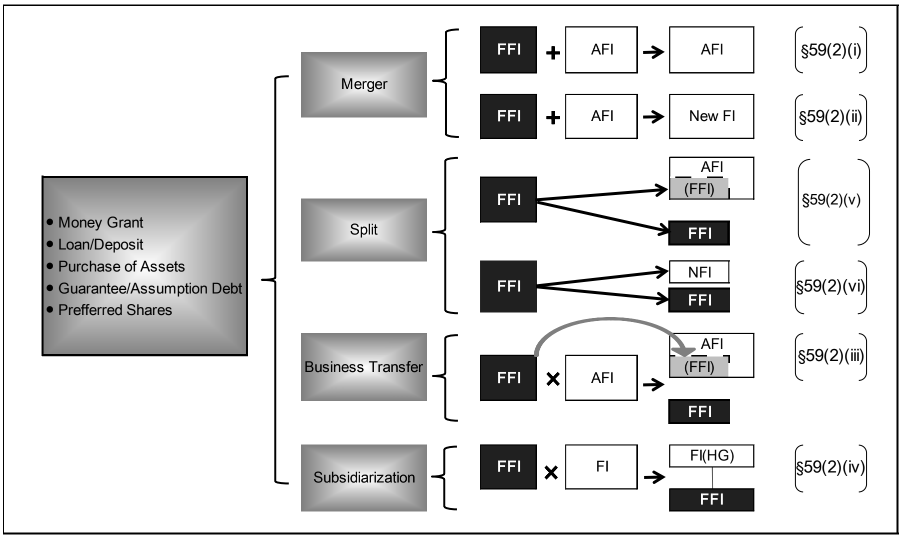
[108] Apart from the DIA, the corporate restructuring operations are defined –and regulated, in anything not covered by the special legislation– by the Japanese Company Law, article 2, paras. XXVI to XXXII, and related legislation.

[109] Art. 59(1) of the DIA.

[110] Art. 64 of the DIA. See, DICJ [2016] p.9.

type of contingency. The assistance will in any case *limited to the amount that would be paid by the DICJ in case the "insurance payout method"* was applied; in other words, the cost of the payment of insured deposits acts as the maximum financial assistance available.[111]

Figure 3 Type of Operations to be Financed



The type of assistance will normally be adjusted to the legal requirements of the restructuring operation. So, for example, in case of a merger or a split, creditors of the non-troubled financial institution would have a right to have their claims guaranteed, or enjoy the protection of a system of joint and several liability. The Act leaves the particular conditions of the operation open. The contract between the DICJ and the parties to the operation will need to define, for example, the time and type of reimbursement of loans or deposits, as well as the interest rate applicable. There seems to be no constraint at the level of the law in this regard,[112] but any condition below market rates would imply a transfer of rents – and therefore a type of bail-out – at the expense of the DICJ (i.e., the financial sector as a whole and the taxpayers). The same reasoning would apply in the

[111] Art. 64(2) of the DIA. The DIA, however, allows the parties to the restructuring operation to require additional financial assistance in case certain conditions are met (Art. 69). Art. 64 (2) of the DIA applies "mutatis mutandis" to Art. 69 (1) and (2), that regulate the additional assistance (Art. 69(4)). Hence, it would seem that this additional assistance would also be capped by the initial amount determined by the insured claims according to the insurance payout method. The reference to the application "mutatis mutandis," though, may leave the interpretation open. Should the limitation apply, the provision of additional assistance would only be possible whenever the initial amounts were lower than potentially possible. The interpretation to extend the cap would in any case be consistent with the general regulation of the use of funds in the rescue of banks, which only under certain circumstances allow to surpass the amounts due under the insurance relationship.

[112] There are, however, rules at the level of subordinate legislation. Although there is no specific article regulating the provision of loans or deposits of funds in the DIA, Art. 26(2) of the "DICJ's Statement of Operation Procedure" foresees that the assuming or the contributing financial institutions would need to satisfy pre-defined interest rates. The said article states that when DICJ lends funds to the rescue of financial institutions, taking into account lending rates of financial institutions, deposit interest rates, and the trend of other conditions, the DICJ shall determine the interest rate and other conditions relating to the loan, and shall request collateral if necessary.

case of fund grants. Naturally, this would not happen if the limit set by the payout of the insured deposits is factored-in when calculating the amount of the loan or the grant.[113]

The financial assistance may be provided directly to the financial institutions participating in the transaction, or indirectly, to a financial institution designated by the Prime Minister to support the restructuring operation (Art. 60 of the DIA). In this latter case, the non-participating financial institution will have to request the financial assistance to the DICJ, and the type of assistance available coincides with the kinds available for the participants in the operation. This financial assistance through a third party would seem to be part of a scheme predefined by the relevant financial authorities, since the said third party institution will be designated by the Prime Minister (i.e., the FSA). Generally speaking, the DIA regulates in some detail the involvement of the Japanese financial authorities –through the Prime Minister- in the strategy and design of the restructuring operations that form part of the financial assistance scheme. It is noteworthy that the DIA (Art. 62) provides explicitly for the mediation of the Prime Minister in order to find one or more financial institutions that are willing to participate in a restructuring operation, in case the lack of a solution to the distressed financial institution poses a risk to the flow of credit and to the interest of consumers in the region (Art. 61(3)(iii)).

Depending on the type of assistance requested, the DICJ may perform the operation indirectly by using a specialized entity. The most salient example is the Resolution and Collection Corporation (RCC), a subsidiary of the DICJ specialized in the collection and recovery of troubled loans. When the assistance provided by the DICJ consists in the purchase of assets, the RCC will be normally engaged to acquire the portfolio and to collect payments, even of those claims considered especially difficult.[114]

[113] The decision may also be influenced by the tax treatment of the operation. The DIA or the Banking Act do not provide a specific regulation as to whether the operation would be subject to taxation. This would be especially important in case of transfer of assets or of the business. The DIA and its supplementary provisions include some special taxation rules, referred to registration and license taxes. Art. 135(1) of the DIA exempts the failed bank and its financial administrator from registration tax when the financial institution is placed under the management of a financial administrator and notified to the Court and the registry; similarly, and the second and third paragraphs of the same article exempt bridge banks from registration tax for property transfer. Furthermore, Art. 22 of the DIA Supplementary Provisions exempts the entities that agree with the DICJ to assume the management of the business, rights and obligations of a failed financial institution (most often, the Resolution and Collection Corporation (RCC)) from registration taxes. None of these provisions are to be deemed sufficient to create an enabling legal framework that facilitates these type of restructuring operations. Best international standards recommend at least a tax-neutral treatment of business restructuring operations (see, Principle of the World Bank´s Insolvency and Creditors´ Rights Regimes Principles 2015, available at http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf).

[114] The RCC has a relatively short but rather successful history. Created in April 1999, it currently has over 330 employees, collection centres in Osaka and Tokyo, and only in 2014 the corporation has managed to recover 48.1 billion yen in debt. For a summary, see RCC [2015]. See also, http://www.kaisyukikou.co.jp/ (although it is only in Japanese).

e. Special reference to the use of a bridge bank

In Japan, in a similar fashion to the US model, the restructuring operations to be undertaken in the context of the financial assistance method may make use of a bridge bank. As it is well known, the bridge bank is an institution that acts as a temporary operational bridge between the distressed financial institution and an assuming financial institution. Its use will become necessary when there is no identified and willing bank to immediately undertake the operations of the failed institution. The bridge bank´s objective is generally to protect depositors and underpin financial stability by ensuring repayment of deposits and continue operations. The failed institution –through its financial administrator,[115] that, as stated, will often be the DICJ– will transfer the insured deposits and good assets to the bridge bank, that will continue to operate the business until an assuming institution is found.[116] The bridge bank will not only deal with the deposits, but will normally continue to "do business" by conferring credit whenever sound projects arise (although the interim nature of the bridge bank forces it to adopt a low profile and a conservative business behavior). Not uncommonly, the bad assets will also be transferred by the financial administrator to the RCC for the maximization of its recovery (here, the RCC would act as a "bad bank," although it has also performed directly the functions of bridge bank in the past.)[117] The operation of the bridge bank in each case is to finalize within two years, with one additional year in case of unavoidable circumstances. The operation shall end with the merger or a split of the bridge bank with another institution, with the transfer of all of the bridge bank´s business or its shares, and with the dissolution of the bank in a shareholders meeting.[118] Naturally, the operations of the bridge bank may also be supported by the financial assistance programme, as explained in the previous paragraphs.

[115] A literal reading of Chapter VI (Arts. 91 *et seq*) of the DIA implies that the utilization of a bridge bank will only take case when the troubled financial institution has been put under the management of a financial administrator (ex Art.74 of the DIA).

[116] The decision as to what assets are transferred would seem to correspond to the financial administrator, although under the authorization of the Prime Minister (Art. 93 of the DIA). The Prime Minister and the MOF are tasked with the pre-determination of criteria and standards of adequacy to form part of the transferrable portfolio of assets. The operations of the bridge bank will be subject to guidelines defined by the DICJ (Art. 94(2) of the DIA).

[117] See, DICJ [2016] p. 21 and RCC [2015] p. 11. The use of "bad banks" has been an instrument constantly used by resolution authorities to deal with bank failure across the world. Since its inception with the US Mellon Bank in 1988 and its full development in the Swedish banking crisis of the early 1990s, the setting up (or use of a pre-existing) financial institution that acquires the troubled assets of a distressed financial institution has proven an efficient tool to ring-fence the risk of the crisis and clean up the balance sheet of the troubled bank to maximize its value and increase its chances of recovery (or a going concern sale). There are different schemes possible, with public or private –but publicly guaranteed– entities, or entities of mixed ownership; fully separate institution or internal bad banks created to hive off bad loans by the same troubled bank when it is large enough; etc. Recently, examples of "bad banks" have been seen in the UK, Germany, Ireland, Portugal or Spain, only to mention some. The key to the success and, ultimately, to the type of use given to the bad bank lies with the price at which the bad assets are acquired.

[118] Art. 96(1) of the DIA.

Two bridge banks have already been used in past operations: the “Bridge Bank of Japan,” incorporated in 2002, dealt with the insolvencies of the Ishikawa Bank and the Chubu Bank in 2004, and is now liquidated; the “Second Bridge Bank of Japan,” incorporated in 2004, allowed for the transfer of the sound business of the Incubator Bank as recently as 2011.[119]

2. Management by a Financial Administrator

The Prime Minister´s issuance of an injunction ordering the transfer of the management of the bank´s business and property to a financial administrator will take place in any of the two following cases: (a) when the managers of the bank have operated the institution in an “extremely inappropriate” manner; or (b) when a restructuring plan, through a financial assistance programme, needs to be implemented to avoid – contained, localised – systemic damage.[120] The order removing the bank´s management is coupled with the appointment of a financial administrator. Although formally the appointment is made by the Prime Minister (Art. 77(2) of the DIA), the name is determined by the FSA´s Commissioner with delegate powers.[121]

As it has been explained in the previous section, the removal of the bank´s management and its substitution by a financial administrator will take place in parallel to the design and implementation of the restructuring operations. In fact, it will be the financial administrator (not uncommonly, the DICJ) to play the leading role in the process. It is noteworthy that the DIA does not seem to contemplate the possibility of a restructuring being implemented by the normal bank management, even if its performance had not been inadequate.[122]

The financial administrator is legally assigned with the widest powers of management and representation: “*When an Injunction Ordering Management has been issued, the right to represent a Financial Institution under Management, execute its business, and manage and dispose of its assets shall be vested exclusively in the financial administrator*” (Art. 77(1) of the DIA). In other words, the management and representative bodies of the legal entity (as determined by the relevant company legislation) are substituted by the incoming appointee, who

[119] DICJ [2016] p.22. The Bridge Bank of Japan was dissolved and liquidated in March 2004(https://www.dic.go.jp/english/e_katsudo/e_hatanshori/e_kakokohyo/e_fy2003/e_2004.3.8.html) and the Second Bridge Bank of Japan was acquired by the Aeon Bank in December 2011(https://www.dic.go.jp/english/e_shinko/e_ukezara/e_ukezara3.html).

[120] Art. 74(1)(i) and (ii) of the DIA. A financial institution that is unable to satisfy its obligations in full or that is likely to suspend repayment of deposits given the state of its business and property must notify in written form the Prime Minister (i.e., the FSA) so that appropriate measures may be adopted (Art. 74(1) and (5) of the DIA). In case this duty is breached, a penalty may be imposed (Art. 151 (1) of the DIA.

[121] DICJ [2016] p. 10. There seems to be a wide discretion to appoint the financial administrator among those highly qualified professionals with relevant experience in financial matters.

[122] This would be the literal interpretation of Art. 74(1)(ii), where the Act links the “carrying out” of the restructuring operation (literally, “merger, etc.”) with the appointment of a new management. This rule would seem to be an instrument for the banking authorities to have full control over the restructuring process. With the DICJ as manager and as provider of the financing needed for the operation, and all under the control of the FSA, the process will be closely harnessed by the banking authorities.

will have the possibility to even sidestep the approval of the shareholders in the appointment of senior management and auditors. The degree of empowerment of the financial administrator –and of suspension of the ordinary company law decision making process– will depend on the financial status of the troubled bank: if the bank is insolvent (i.e., balance sheet insolvency: inability to satisfy its obligations in full with its assets, in accordance with Art. 87(1) of the DIA), a Court approval may substitute the shareholder meeting for decisions of the highest relevance, such as the issuance if class shares, the reduction of capital, the transfer of all or part of the business or a company split; in other cases, however, the DIA simply states special majorities which are different – lower than – the ones envisaged in Japan´s relevant corporate legislation.[123] The financial administrator will run the business, resume operations and seek a solution by looking for one or more assuming financial institutions. The administrator will also undertake other classic functions of insolvency representatives, such as the preparation of reports on the status of the business and the causes of the distress, or the filing of suits to establish the liability of the management of the bank.

The direct intervention of a Court poses the problem of determining which court is competent to authorize the operations. The solution would seem evident in case the appointment of a financial administrator had been accompanied by the petition to commence Civil Rehabilitation proceedings (as seems to be the rule). Although Art. 87 of the DIA – or, indeed, the entire Act – makes no reference to the court competent to conduct insolvency proceedings (of any of its 3 kinds), the application of general tenets of insolvency law would suffice to assign competence to the judge tasked with the insolvency case: all of the operations described in Art. 87 refer to the insolvency estate or affect the business, and, therefore, the *vis attractiva concursus* seems undeniable.[124] But since the CRA already includes rules that are all but identical to Art. 87 of the DIA, the latter article must be referring to a different court (i.e., establish a rule for the case in which there are no parallel insolvency proceedings). The solution is not so evident then. One possibility is to understand that the relevant Court is the same Court that received the notification of appointment of the financial administrator prescribed in Art. 79 of the DIA (i.e., the Court where the bank has its head office). The alternative is to interpret that, since Art. 87(12) does not generally excludes them, the general principles of jurisdiction included in the Non-Contentious Case Procedures Act are applicable.[125]

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[123] Art. 86 of the DIA and Art. 309(1) of the Companies Act (Act No. 86 of July 26, 2005, amended).

[124] The CRA assigns competence to the insolvency judge to decide on new or on-going actions against the debtor, to solve avoidance actions or to generally decide litigation that affect the debtor´s insolvency estate (Art. 39(2) of the CRA).

[125] Law No. 51 of May 25, 2013. The uncertainty about the competent court stems from the strict lack of cross reference and coordination between the DIA and other laws relevant to the application of restructuring operations. This could generate a more relevant problem concerning the legal regime applicable to the restructuring operations to be undertaken under the management of the financial administrator or, more generally, under the financial assistance programme. In the absence of special reference in the DIA, it would seem that the general corporate, contract or procedural laws would apply. However, their application would need to be made consistent with the special situation and characteristics

3. The parallel use of general insolvency proceedings

From the formal and procedural point of view, the interaction between the DICJ and the Court proceedings as described for non-systemic financial entities applies, *mutatis mutandis,* to the case analyzed in this section. There are, however, new elements to consider. The appointment of a financial administrator will render the activity – and even the appointment – of a parallel insolvency representative all but futile, at least until the material restructuring operations have been agreed and concluded. The wide set of powers conferred upon the financial administrator by the DIA would leave no space for another representative to act with regard to the business, assets and liabilities.

The DIA and the general insolvency laws do not provide sufficient coordination rules. In case of Civil Rehabilitation proceedings, the debtor continues to operate the business, with the right to dispose of its assets (i.e., DIP or Debtor in Possession), and it is therefore not necessary to appoint representatives, whereas in the case that a representative is appointed, either under the CRA or in the case of Corporate Reorganization proceedings, the coordination between the tasks of the financial administrator and the general insolvency representative would seem unclear. It remains unclear what type of actions could the parallel representative undertake and how, although access to the Court would seem undeniable. The representative would also need to ensure that the hierarchy of claims foreseen in insolvency is respected, once the special banking rules have been applied. The coordination and exchange of information between the DICJ or the financial administrator appointed, the RCC if involved, and the insolvency representative should be fluid.[126]

4. Loans for the Settlement of Obligations

One of the instruments provided by the DIA to protect financial stability is to protect ongoing operations and the settlement of obligations to which the troubled financial institution is a party. Within the limits set forth by the calculations of the insurance proceeds ex Art. 54-2 of the DIA, the DICJ may –when found necessary – provide loans for the repayment of the exchange transactions to troubled financial institutions (Art. 69-3 of the DIA). The requesting financial institution may be under the management of a financial administrator or immersed in one of the general insolvency proceedings.[127]

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of the crisis of a financial institution and its special framework. The system might benefit from more express rules that avoid problems of consistency.

[126] In any case, perhaps the need for express coordinating rules between regulatory resolution and insolvency proceedings are one of the most pressing needs for reform in the Japanese system.

[127] For further considerations on this topic, with regard to the settlement of obligations with systemic relevance, see, Part IV.E.2.

C. The Financial Distress of Locally Systemic Banks: Avoiding Financial Crisis

The DIA very explicitly labels the situation as the adoption of "Measures against a Financial Crisis" (Chapter VII). The crisis is defined as the risk that the distress of a financial institution "*may extremely seriously* [sic] *hinder the maintenance of an orderly credit system in Japan or in a certain region where said Financial Institution conducts its business*" (Art. 102(1) of the DIA). The increased gravity in comparison with the case described in the previous section is reflected in the degree of damage, in the threat to the entire credit system, and in the scope of the danger, that should be national or, at least, regional. This could happen because of the size of the entity, its particular strategic area or region of operation, or even because of a general economic or financial situation of instability in a given moment enhances the risk of contagion and makes more drastic measures advisable. Again, it is a very general definition, which allows the relevant authorities to call the triggers and use the instruments with a relatively high degree of discretion. The decision as to when the distress of a given institution may create a threatening general financial crisis corresponds –again– to the Prime Minister, although, this time, only following the deliberation of the FCRC.[128] The concrete measures will be decided by the FSA´s Commissioner, subject to the consent of the MOF and, in case of special financial institutions, by other Ministers.

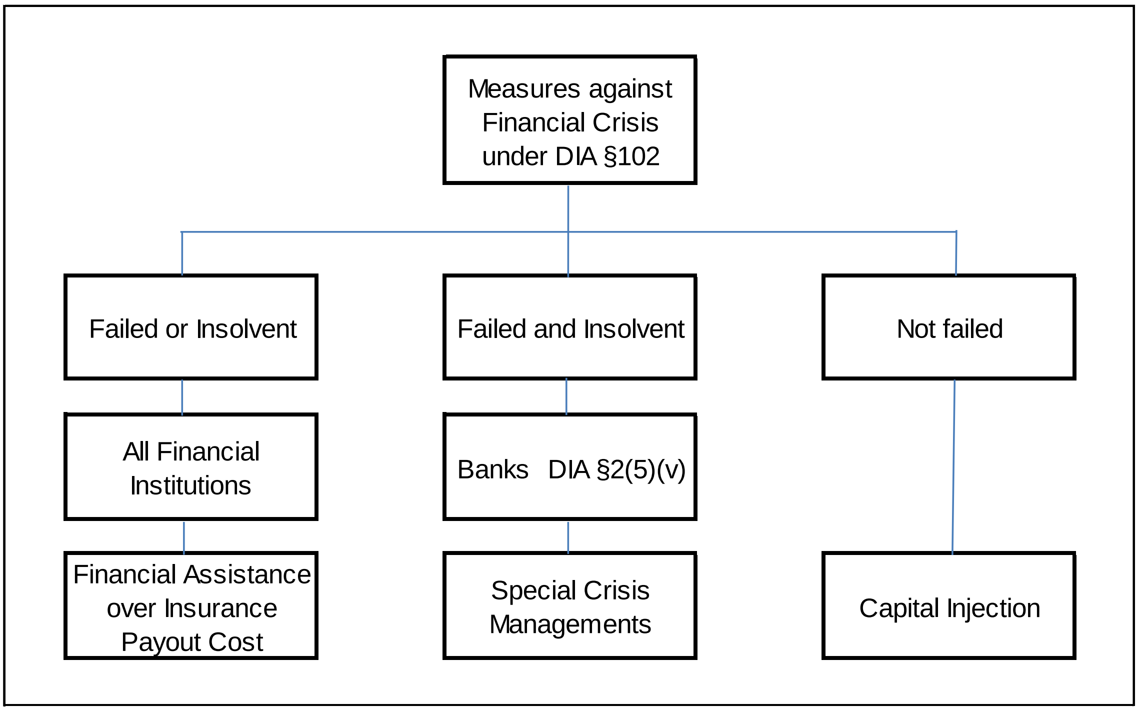
The Japanese system includes a wide battery of measures to confront this type of cases. In this section we will only refer to the ones that are specific of a situation of possible financial crisis, but the PCA, the appointment of a financial administrator, the adoption of financial assistance measures and the parallel opening of insolvency proceedings may also apply to some –albeit not all– of the situations covered by this section.

The DIA differentiates the measures depending on whether the financial institution is a Failed –insolvent– Financial Institution or not [129] as well as on the type of financial institution concerned (see Figure 4).

[128] For the definition and membership of the Council, see *supra* note 61 and its accompanying text.

[129] As stated previously, the DIA (Art. 2) defines a failed financial institution as one that has suspended the repayment of deposits or is likely to do so given its situation.

Figure 4 Outline of Measures against Financial Crisis under DIA§102



1. Solvent/Non-Failed Financial Institutions

When a solvent but financially distressed financial institution creates a national or regional systemic risk, the DIA system adds a new instrument: the increase of the financial institution´s capital level with funds provided by the DICJ.[130] The Act labels this instrument as "*capital injection.*" Since, by definition, the financial institution is not a failed financial institution, the reinforcement of the capital is to be requested by the management of the financial institution, and, in fact, the Act would seem to conceive a situation where the troubled entity has its own management in office. It is unclear whether the appointment of a financial administrator is possible in the context under analysis. A literal interpretation of Art. 102(1)(i), combined with the reading of Art. 74 of the DIA, would seem to deny the possibility of a financial administrator being appointed to manage the troubled entity: Art. 102(1)(i) expressly excludes from its scope the "*Financial Institutions specified in the following item* [...]*,*" and the said item (Art. 102(1)(ii)) refers to a *"Failed Financial Institution or a Financial Institution that is unable to satisfy its obligations in full with its assets."* Further, Art. 74(3) states that the issuance of an order removing the management and appointing a financial administrator turns the financial institution into a Failed Financial Institution in any case. So the loop is complete: the appointment of a financial administrator would deny the possibility of a capital injection. Similarly – and *a fortiori* – the commencement of a Civil Rehabilitation case would also prevent the capital injection

[130] This recovery mechanism was famously used to solve the crisis of the Resona Bank in 2003. For a description of this case, see Part VI.B.1.

instrument to be used, since the ordinary operation of insolvency proceedings would place the institution in a situation of possible suspension of repayment of deposits. We are, thus, before the only measure that is independent from the usual scheme of bank recovery and resolution envisaged in the DIA.

The provision of capital injection by the DIA will be done through the subscription of equity or equity-like securities (of the financial institution or of its holding bank): a) ordinary equity (shares); b) preferred shares; c) subordinated bonds (debt securities subordinated in the contract of issuance); or d) subordinated loan agreements (loans for "consumption," subordinated in the contract of creation). [131]

The sequence of the procedure would seem to have different stages. First, the troubled financial institution should obtain a "confirmation" of the need to obtain a capital injection from the Prime Minister. Although there is no express regulation in this regard, allegedly confirmation cases are issued following decision by the FSA, without the need for a previous petition by the financial institution itself.[132] The confirmation will include a date within which a formal petition will need to be presented, this time –no doubt – by the financial institution requesting assistance (Art. 102(4) of the DIA). In fact, despite the confirmation, the financial institution may present a plan that is alternative to the request for DICJ-provided capital injection via equity and equity-like instruments (Art. 104(1)). This alternative plan, labeled "Plan Specifying the Measures to Enhance the Adequacy of Equity Capital," must be presented to the Prime Minister within the same date as prescribed for the "confirmed" ordinary capital injection plan.[133]

The formal petition will be presented to the DICJ. If all requirements are complied with, the DICJ, jointly with the petitioning entity, will request a final decision from the Prime Minister (and, depending on the type of institution, certain Ministers) on the approval of the specific capital injection measures requested. The petition will also include a "Management Soundness Improvement Plan", which is defined as *"a plan to improve the soundness of business management* [...] *setting forth the measures to streamline the management and to establish a*

[131] See, Art. 2(9) and (8) of the DIA.

[132] Since the law does not provide express guidance, on the face of it, a request could come from the entity or also from an act of a Ministry or public agency. Art. 102(1) simply states that the confirmation will come when the Prime Minister finds that, unless measures are adopted, a systemic risk may ensue. This would seem to leave open the question of where the information that leads to the Prime Minister´s "finding" comes from.

[133] The Prime Minister may approve the alternative plan if it is found adequate, following the opinion of the FCRC. If considered inadequate, the initial confirmation will be removed, and it would seem like the only possible course of action would be for the Prime Minister, having heard the opinion of the Minister of Finance, to confirm a measure of Art. 102(1)(ii) (see, Art. 104(8) of the DIA). This solution seems confusing. Although no specific regulation is included, it would seem inevitable that a measure under Art. 102(1)(ii) could only be determined if all the requirements for such decision are met (i.e., the failure/insolvency of the financial institution). In any case, it seems unclear why the rejection of the alternative plan should bring about the "rescission" of the initial confirmation: especially if the situation of the financial institution, while still solvent, continues to pose a systemic risk.

responsible management system [...]" (Art. 105(3) of the DIA).[134] The capital injection shall be authorized by the Prime Minister, with the agreement of the Minister of Finance (Art. 105 (4) and (5) DIA), if: (i) the petition is adequate and sufficient to stave off the risk of systemic damage, (ii) the type of shares/equity is valid for the purpose of the capital injection, and (iii) the financial institution assumes the obligation to implement the accepted measures to improve management efficiency, and to adopt measures to clarify the possible existence of management responsibilities or the liability of shareholders (as the case may be).

The DIA regulates the possibility that the Prime Minister´s "go ahead" be linked with a reduction of capital of the troubled institution (Art. 106 of the DIA). The reduction may apply to all shareholders or only to one class. Normally, this type of measure would be imposed with a view to bail-in shareholders, minimize public spending and exert a higher degree of control over the entity (by controlling its shareholding). *But the DIA leaves the decision to the shareholders meeting of the petitioning financial institution in this case*. If the shareholders do not meet to adopt a decision, or decide against the capital reduction, the "confirmation" of the operation will be "rescinded." This rule would seem at least debatable on its merits, and perhaps not fully consistent with the general approach –of high powers of the public agencies– adopted in the Japanese system. There are two arguments in favour of giving shareholders the option to block an agreement: on the one hand, the capital injection procedure is based on the voluntary action of the financial entity (and hence, it would seem reasonable to expect a positive vote in the meeting, or the procedure would not have been triggered at all); on the other hand, this procedure only applies to troubled-but-solvent financial entities, and therefore –it can be argued– the expulsion of equity holders would not be justified in economic terms. However, allowing equity holders to block a restructuring operation would seem to contradict the main aim of the banking recovery system, which is to avoid contagion and systemic damage, and would seem inconsistent with both the powers conferred under the preventive action mechanisms (PCA) and the tenets that shareholders must the first to account for the losses of a financial institution (i.e., to be bailed-in) in order to avoid further damage to the taxpayer´s pocket.[135]

The capital injection and linked –instrumental– operations, like a capital reduction, are not the only possible courses of action. The DIA expressly envisages and regulates in detail the

[134] The Management Soundness Improvement Plan shall be made public, excluding from it any information that may harm the financial system, disseminate private information of depositors or clients, or in any way damage the business prospects of the financial institution that receives the capital injection (see, Art. 108(1) of the DIA).

[135] Arguments in favour of the DIA´s solution being consistent and correct have been expressed by Yamamoto [2014]. The author argues that giving equity holders a chance to vote at the shareholders' meeting under Art.126-2 (early stage resolution) is correct, since shareholders have not fully lost the economic value of their rights as long as the financial institution is solvent (not failed) and shareholders will have an opportunity to be compensated for their loss if the economic value of their rights is deteriorated. The same logic should apply to cases under 102(1)(i) case. This seems to be a generally accepted explanation in Japanese academia. This interpretation would run counter the extensive bail in powers granted to resolution authorities in the most recent bank resolution systems (see, for example, the EU´s Bank Recovery and Resolution Directive (Arts. 37, 44 *et seq* and 59 *et seq*).

implementation of corporate reorganization measures that ought to be linked with the Management Soundness Improvement Plan after the capital injection (Art. 108-3(1) of the DIA). These operations could include a total or partial sale of the business, a merger, a split or other restructuring measures similar to those contemplated for the financial assistance method, and they could be implemented directly between the financial institution and one or more third financial institutions, or worked through the intervention of a Bridge Financial Institution (in which case, a specific Management Soundness Plan for the Bridge Financial Institution will be necessary). In any case, the said corporate reorganization ought to be subject to the authorization of the Prime Minister (and certain Ministers, depending on the type of institution) (Art. 108-3 of the DIA).[136]

2. Financial Assistance over Insurance Payout Cost for Insolvent/Failed Financial Institutions

Financial institution whose size, type of business or circumstances create a systemic risk of the type under consideration, that are failed or insolvent, may receive *enhanced financial assistance* from the DICJ. The main difference with the financial assistance available for the smaller entities analyzed in the previous section lies with the removal of the quantitative limitation. For systemically relevant entities, the financial assistance is made available "[...] *for an amount that is expected to exceed the expected* [sic] *costs for the payment of insurance proceeds with respect to an insurable contingency* [...]" (Art. 102(1) (ii) of the DIA). In other words, the direct or indirect financial assistance to an assuming financial institution to support a merger, a split or a business transfer may be larger than the "payout" cost ordinarily covered by the deposit insurance scheme. We are, thus, before a very powerful instrument, which can be used to cover the full repayment of depositors or the bailing out of other creditors.

Because of its relevance (and its possible cost for the tax payers), triggering this measure implies the parallel petition of an order removing management and substituting it by a financial administrator. This will happen mandatorily, and in any event: because the Prime Minister has confirmed the trigger of Art. 102(2)(ii) or because the capital injection mechanism failed (i.e., the solvent financial institution did not request a capital injection on time and did not present an

[136] Normally the amount of capital will be provided in an amount sufficient to uphold the solvent, ordinary continuation of the financial activity of the assisted entity and hence there should be no need for additional assistance of any sort. However, in certain cases it might be convenient, for operational reasons, to provide financing to support a corporate restructuring. This possibility is not expressly stated in the relevant articles regulating the reorganization measures, and a literal interpretation of the DIA would seem to deny this possibility. Any financial assistance for implementation of the reorganization would need to be made available to the assuming or contributing financial institutions through the mechanisms and with the requirements set forth in Arts. 59 *et seq*. of the DIA. However, in order for these provisions to be applicable, the DICJ ought to be persuaded that, unless the operations take place, there is a probability that the financial entity will not be able to pay its deposits in the future (in other words, that it is a "failed financial institution" as defined in Art. 2 of the DIA). And failed financial institutions are out of the scope of Art. 102(1)(i).

alternative plan, or the plan presented was deemed inadequate, or the shareholders meeting did not approve the mandatory capital reduction) (Art. 110(1) of the DIA).[137]

Through the use of this instrument, the DICJ is assuming a role that goes beyond its task as a deposit insurance institution. *By providing financial assistance that is beyond the scope of insurance relationship, the Corporation becomes a public instrument to achieve financial stability*. Furthermore, the DICJ may need to resort to funds that will have to be ultimately paid out of the pocket of third parties alien to the original insurance relationship: either other financial entities (the group of participants in the deposit insurance system) or the Government of Japan. Because of this, a system of special accounts, monitoring and cost allocation is set up by the DIA. Because this type of situation is likely to happen in much higher measure in the case there described, both the special accounts and the loss allocation mechanism will be analyzed in the next section.

3. Special Rules for Insolvent/Failed Banks: the "Special Crisis Management"

Probably because of the Japanese experience with painful banking crises and its objectively

greater destructive potential, the Act reserves the most wide-encompassing and powerful restructuring instrument for the insolvent banks [138] (Art. 102(1)(iii) of the DIA). Following a decision by the Prime Minister (adopted following the technical decision of the FSA represented by its Commissioner), the DICJ shall acquire the shares of the failed financial institution, "nationalizing" *de facto* (not strictly *de jure,* since the DICJ is not part of the national Government) the institution. The nationalization is presumed to be only temporary, until the execution of the restructuring operations allows for its sale/transfer and the recovery of the public funds. The said bank will be regarded as a "Bank under special crisis management". This measure can only be adopted when the Prime Minister is persuaded that the provision of unlimited financial assistance (as established in Art. 102(1)(ii) of the DIA) *would not be enough to remove the systemic danger* (Art. 102(4) of the DIA).[139]

The bank under Special Crisis Management will be put under control of the FSA through the DICJ. The following are the main items of the "Special Crisis Management" regime:

[137] According to Art. 110(1) of the DIA, the Prime Minister will issue the "injunction" ordering a substitution in the management of the entity "*notwithstanding the provisions of article 74, paragraph(1) and (2)*", which should be read to mean that the absence of any of the requirements set forth in such paragraphs would not prevent the appointment of the financial administrator from taking place.

[138] The scope of this section is limited to all banks (as described in Art. 2(1) of the Banking Act) and long-term credit banks. See, Art. 2(5)(v) of the DIA).

[139] The "Special Crisis Management" mechanism was used to handle the crisis of the Ashikaga Bank between 2003 and 2008. For a description of this case, see Part VII.B.2.

a. The Acquisition of the Equity

The acquisition of the shares takes place automatically by virtue of the public issuance of a notice[140] including the decision of the Prime Minister to commence a Special Crisis Management on the failed bank (Art. 112 of the DIA). There is no need for further action to transfer ownership; share certificates are deemed invalid; and certain general rules of company law are left inapplicable to the case.

b. Financial information

The decision to commencement a "Special Crisis Management" will be notified to the bank and the DICJ, and made public in the Gazette (Art. 111(2) of the DIA). The main financial accounts (value of assets and amount of liabilities) of the bank will also be made public as of the date of issuance of the publication (Art. 113 of the DIA). Further, the Prime Minister may also order the bank under special management or its financial agent (i.e., a financial institution that performs banking activities for the failed bank through a contract) to submit anytime reports, to provide material regarding the business or the assets of the bank, or to draft a management plan or other measures that are regarded as necessary (Art. 115 of the DIA).

c. Takeover of the Bank´s Management

The DICJ may remove the bank´s management, financial officers and auditors, and replace them with a new executive officer and a new team. For that, the DICJ will need approval of the Prime Minister (Art. 114 of the DIA). The DIA waives the ordinary corporate law mechanisms for the appointment and removal of a corporation´s senior managers and accounting auditors.[141] The new management of the bank has the duty to seek the liability of the previous management when there appears to have been a breach of duty,[142] and generally its newly appointed staff to take any necessary measures to allow for the prosecution of those who committed civil or criminal offences (Art. 116 of the DIA).

d. The Operations to Exit the Situation of "Special Crisis Management"

The exit to the crisis is to be achieved as soon as possible. It may essentially consist of any of the exits foreseen in Art. 59 of the DIA for the financial assistance method: an absorption of the failed bank by an assuming financial institution, a merger with the creation of a new entity as a result

[140] See, Art. 111 of the DIA.

[141] Since the bank´s shares will be fully owned by the DICJ, this legal rule can only be understood as a way to speed up the implementation of the measures.

[142] From the literal wording of the article it cannot be extracted that the action – and the liability – should take place in every case. There has to be an appearance of mismanagement and, in accordance with general corporate liability in Japan, at least negligence will have to be established (see, Arts. 423 and 429 of the Company Law).

thereof, a total or partial transfer of the business, or the transfer of the failed bank´s shares or the split of all or part of the business and its incorporation into an assuming institution or a newly created one. [143] And those exits may be implemented by means of an adapted version of the financial assistance rules of the law (Arts. 59 et seq. of the DIA). [144] As stated above, the financial assistance available for the operation is not limited by the insurance payout cost, so that all depositors and other creditors may be protected if the FSA and Minister of Finance consider it necessary to avoid the consequences of the systemic risk posed by the bank´s insolvency.

The DIA does not make reference to any other kind of parallel proceedings. Provided that all the shares of the bank under Special Crisis Management are in the hands of the DICJ, and that the agency has the possibility to control the management and financial departments, it would seem futile to have a financial administrator appointed. However, the conclusion might be different concerning the petition for Civil Rehabilitation proceedings. While the application of Civil Rehabilitation proceedings might make sense in order to benefit from stay orders and other rules to recover value or protect the existing value of the business (avoidance actions, etc.), the petition for liquidation following the execution of the exit (sale of the shares, merger, etc.) would seem even necessary. [145]

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[143] Art. 120 of the DIA.

[144] Art. 118 of the DIA.

[145] Japanese law allows for the extinction of a company through a number of mechanisms. In case of solvent entities, it is –naturally– the Companies Act that provides a path to end the entity´s existence, and one of the causes for the extinction is the opening of insolvency proceedings. This is done through the classic two-stage civil law procedure, with first a dissolution (which may come as a decision of the assembly of members or automatically, depending on the cause), and after a winding up of the affairs of the business and the liquidation of its assets. This is envisaged in Art. 471 of the Companies Act, which states that "*A Stock Company shall dissolve on the grounds listed below:* […] *(v) A ruling to commence bankruptcy procedures* […].*"* Further, Art. 476 of the same law reads as follows: *"Stock Companies that go into liquidation under the provisions of the preceding article (hereinafter referred to as "Liquidating Stock Companies") shall be deemed to remain in existence until the liquidation is completed, to the extent of the purpose of the liquidation"*. A joint reading of both articles provides a clear rule: where "bankruptcy procedures" are commenced, the company is automatically dissolved and its operations are only aimed at the liquidation of the assets and the extinction of the entity as a result thereof. Not only the Bankruptcy Act (Art. 35) but also the Corporate Reorganization Act (Art.185) foresee their own procedure to extinguish companies following the full implementation of the plan or the liquidation of the insolvency estate (but the CRA doesn't have an express provisions to extinguish companies, the possibility seems to be common in practice). It is thus not clear how and when a legal entity may be extinguished through the company law procedure having undergone insolvency proceedings (of any kind). Moreover, the more probable interpretation would be that it cannot; that liquidation following the company law procedure may only happen in case of *solvent entities*. Under this interpretation (which would be aligned with the interpretation of a very similar legal framework in Germany, Spain or Italy, to mention only some examples), Arts. 471 and 476 of the Companies Act would merely be stating that, in case of insolvency –of any kind– the company cannot continue its operations as usual, and must enter a situation of dissolution, with limited ability to act. The limitation of the Companies Act, though, must be complemented –and superseded– by the regulation of the relevant general insolvency law. It is indeed unclear to us how a bank may have been extinguished through the company law procedure, unless it had been made solvent through the DIA and the relevant insolvency proceedings before (see, the case of the Incubator Bank, Part VI.B.3). This last interpretation could be supported by Art. 475 (i) of the Companies Act, that states: "A Stock Company must go into liquidation in the cases listed below […]: (i) In cases where the Stock Company has dissolved (excluding the cases where

D. Orderly Resolution of Systemic Financial Institutions

In order to incorporate the latest agreements of the Financial Stability Board (FSB) concerning systemic risk of financial markets, Japan approved in 2013 an important reform of the DIA. Although changes touched upon different parts of the Act, the main bulk of the reform consisted on the inclusion of Chapter VII-2 , entitled "*Measures for Orderly Resolution of Assets and Liabilities of Financial Institutions to Ensure the Stability of the Financial System*". The self-expressive title captures the essence of a reform that brings into the Japanese financial system some of the most up-to-date ideas on bank recovery and resolution. The new provisions do not only furnish the banking system in Japan with powerful tools to deal with the turmoil and risk of contagion originated in the ever volatile financial markets –national and international– from a macro-perspective, but it also introduces for the first time a holistic treatment of the distress of financial entities, covering not only banks and deposit-taking institutions, but also bank groups, insurance companies and funds and investment entities.

The definition of the type of systemic risk to be tackled with these reform is included in Art. 126-2 of the DIA (which is the equivalent for this level of risk to Art. 102 of the DIA for the national or regional systemic danger): the measures to be adopted are aimed at preventing a "[...] *severe disruption in Japan´s financial markets and any other financial system*". The risk refers thus to a grave collapse of the nation-wide Japanese financial markets (not only the banking sector), as well as to the possible spillover effects from or to other financial markets (even abroad). The newly implemented system has also an international –cross border– component, in line with the efforts of the FSB, the BIS and other international organizations tasked with the surveillance and support of the stability of the world´s financial markets.[146]

The system is designed in a manner similar to the rest of recovery and resolution mechanisms as described in previous sections of this paper. These measures are said to conform a system for the "orderly resolution of financial institutions,"[147] although it is wider and goes beyond mere resolution exits. The decision as to the commencement of the measures –and of most specific decisions of relevance– is attributed to the Prime Minister, with the assistance of the deliberation of the FCRC (and, in the case of certain financial institutions, the opinion of Ministers related to

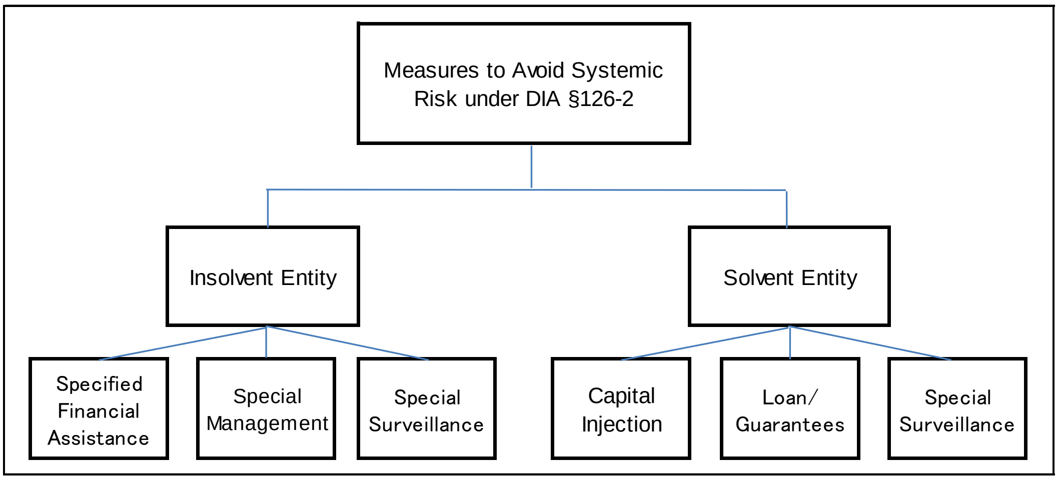
Stock Companies have dissolved on the grounds listed in item (iv) of Article 471 and cases where it dissolved as a result of the ruling to commence bankruptcy procedures and such bankruptcy procedures have not ended)". This could be read as making company law liquidation mandatory whenever "bankruptcy procedures" have ended and the entity has not been extinguished.

[146] The DIA now pays attention to the insolvency of branches of foreign financial institutions, and provides rules for the coordination of insolvency proceedings over a foreign institution commenced abroad but with interests in Japan, the regulation of cross-border issues is rather scarce. The Act contains a general clause mandating the DICJ, when there is a need to conduct its operations under international cooperation, to "carry out an exchange of information with foreign Governments, foreign local public entities, foreign central banks, international organizations and other bodies equivalent thereto, as well as other necessary operations" (Art. 137-5 of the DIA).

[147] See, DICJ [2016] p. 12.

the activity or type of institution). The decision to start one of the procedures envisaged in this section is labeled "*Specified Confirmation*", which, once adopted shall be reported at the national Parliament.[148] The specified confirmation may refer to a number of measures and actions that differ depending on the financial status of the institution. As in the previous section, the main divide lies between solvent and insolvent financial institutions; and then, among each term of the divide, there are further subdivisions depending on the needs and the risk existing in each case (see Figure 5).

Figure 5 Outline of Measure against Financial Crisis under DIA§126-2



1. Measures for Solvent Systemic Financial Institutions

The DIA envisages a set of specific rescue instruments for "solvent"-but-troubled systemically relevant financial entities. By "solvent", the law understands "balance-sheet solvent" (i.e., assets are enough to satisfy its liabilities.) [149] To tackle the risk caused by a distressed financial institution of the kind analyzed here, the DICJ operates on three fronts: (i) the business is stabilized, monitored, and restructured by means of the regime of "Special Surveillance"; (ii) the main operations of the financial institution (those with systemic relevance, and strategic claims) are salvaged and satisfied through the provision of liquidity; and (iii) the entity itself is protected by the subscription of capital. The triple action serves the purpose of stabilizing the business, of guiding it through to financial and economic soundness for the sake of a transfer or acquisition, and of minimizing risk to the market by ensuring the relevant transactions are honored without disruption.

In summary, the measures (labeled "Specified Measures under Item (i)") consist of the following.

[148] Art. 126-2(1) and (9) of the DIA.

[149] See, *sensu contrario*, Art. 126-2(1)(i) of the DIA.

a. The "Ordinary" Special Surveillance

The declaration of "Specified Confirmation" comes along with a "Designation of Special Surveillance", that automatically places the financial institution under the control of the DICJ (Art. 126-3(1) of the DIA). The institution´s management is not substituted or replaced, but the business activity, management and disposition of property are made subject to the necessary "advice, instructions or recommendations" of the DICJ.[150] This system of control is complemented and enhanced by the law´s empowerment of the Prime Minister to dictate specific measures concerning the business, the management or the disposition of assets whenever it is deemed necessary (Art. 126-3(3) of the DIA). The situation of surveillance will be made public, and the financial institution will be permanently subject to the need to provide reports or generally information as requested by the relevant Authority.[151] The financial institution may also be required to present a plan for its future management to the DICJ and the Prime Minister. The plan would normally include a reduction in the systemically risky transactions. The DICJ may entrust the surveillance of a financial entity to a third party (Special Surveillance Agent) with the authorization of the Prime Minister. There is no objective limit as to the specific scope of the delegation.[152] The surveillance regime is conceived to last for one year, although circumstances may make it necessary to extend it.[153]

b. The "Extraordinary" Special Surveillance"

The DIA provides special rules for the situation where the Special Surveillance has been designated and the financial institution is either balance sheet insolvent or will be so in the future, or has or is likely to suspend the repayment of its debts and compliance with its obligations (Art. 126-13 DIA).[154] In other words, there are special rules for situations of "Specified Measures

[150] Art. 126-3(2) of the DIA. It is noteworthy that the legal expression "advice, instructions or recommendations" would seem contradictory. While "advice" and "recommendations" convey the same idea of guidance or non-binding opinions, "instructions" would seem to imply a course of action that is to be adopted by the institution. Given the situation of the financial institution, the risk that its distress generates to the market, and the general approach of the Japanese system, it would seem difficult to understand the opinions –given by the DICJ as non-binding for the entity under surveillance.

[151] Art. 126-3(4) of the DIA.

[152] Art. 126-4 of the DIA. The legal nature of the DICJ (as a public institution subject to administrative law in its activity or not) becomes relevant when it comes to determine the legal relationship between the DICJ, the Agent and the financial institution or third parties with an interest in the surveillance. The use of the term "Agent" would seem to refer to an agency relationship, shape under private law. However, if the tasks of the DICJ are conceived as public competences, the relationship between the DICJ and its "agent" would be one of administrative delegation, with all that relationship entails (for example, the DICJ´s retaining of the competences, that are only temporarily "shared" with the delegate; or the system of liability for damage caused by the "delegate" to the financial institution or to third parties).

[153] Art. 126-12 of the DIA.

[154] Please note that the situation of "Extraordinary" Special Surveillance (i.e., the court´s authorisation substituting an extraordinary resolution of the shareholders´ meeting) may also take place under the following section (in case of "Specified Measures under Item (ii)," i.e.,"insolvency" of the financial institution). It is, however, explained in this section because in case of "Specified Measures under Item (ii),"

Under Item (i)" applicable to "solvent" entities. The rules include very substantial exceptions to the decision making process of joint stock companies, allowing the financial institution under surveillance to (i) amend articles of association to issue certain classes of securities, (ii) reduce the capital figure, (iii) transfer all or part of the business or even (iv) execute a company split only with the authorization of the Court.[155] In line with these extraordinary powers, the DICJ may dismiss and replace the executive officer, directors, financial officers or the auditors with permission of the Court.[156]

c. The Provision of Liquidity

The financial institution may request from the DICJ a loan or the guarantee of debts to continue its activity, prevent default and avoid causing a disruption to the financial system. The Policy Board of the DICJ is competent to adopt the decision. The repayment of the loan or the reimbursement claim of the debts satisfied to third parties are to be deemed "preferred over other creditors". More precisely, the claims of the DICJ will rank below the "general statutory liens" regulated in the Civil Code.[157]

d. Capital Injection

The financial institution may request from the DICJ to subscribe shares and other equity-like securities.[158] The size of the capital injection is left open, with some degree of discretion for the relevant Agencies. It will be determined based on the necessity to enhance the adequacy of equity capital or "otherwise improve the financial condition" of the bank.[159] As in the case of Art. 102 of the DIA, a period of time to request the capital injection will be set by the Prime Minister and made public[160]; and, as an alternative, the financial institution has the possibility to present a plan proposing measures to enhance the capital adequacy or recover financially without the subscription of shares.[161] If the period expires, or if the plan is not convincing, the possibility of a capital injection vanishes and the Prime Minister, having heard the Minister of Finance, will rescind the situation of Specified Confirmation. Also as is the case in the previous section, the petition for the subscription of shares will need to be coupled with the submission of a

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the appointment of a financial administrator ex Art. 126-5 would seem to be highly probable (whenever the Prime Minister finds that any of the requirements prescribed in paras (1)(i) and (ii) of Art. 126-5 are met).

[155] The competent Court will be the District Court of the place where the main Head Quarters is located (and, in case the Head Office is in a foreign country, the place of the principal office in Japan) (Art. 126-13(10) of the DIA).

[156] These officers will resign at the end of the Special Surveillance and a new management shall be appointed. See, Art. 126-13(4), (6) of the DIA.

[157] Art. 126-19 of the DIA.

[158] Art. 126-22 of the DIA.

[159] Art. 126-2(5) of the DIA.

[160] Art. 126-2(5) and (7) of the DIA.

[161] Art. 126-21 of the DIA.

"Management Soundness Improvement Plan" for the future activity of the financial institution, plan which will be made public with the limitations described for the case of Art. 102 type of situation. The Prime Minister´s decision to allow the injection of capital will be made dependent on: (i) the adequacy of the shares or capital instruments to be subscribed, (ii) the entity remaining balance-sheet solvent, and (iii) the expectation that the petitioning institution will execute the Plan, streamline management and make managers and the relevant shareholders accountable (Art. 126-22(6) DIA).

If, in the process of implementation of the aforementioned measures, the financial institution becomes insolvent in the sense given to it by Art. 126-2(1)(ii), the Specified Confirmation will be rescinded and an "Item (ii)" situation commenced.

2. Measures for Insolvent Systemic Financial Institutions

The law describes the situation of "insolvency" that gives way to a confirmation of "Specified Measures Under Item II" in a very broad way: the inability to fully repay its debts with its assets (balance-sheet insolvency), or the likely or actual suspension of payments of its debts/satisfaction of its obligations (potential and actual cash-flow insolvency) (Art. 126-2(1)(ii) of the DIA). Since the "likelihood" is undefined, the *financial authorities have wide description* to choose which set of measures to resort to upon the occurrence of signs of distress in a systemically relevant financial institution. The wider, the more powerful the instrument.

Here, the DIA provides the most clear example of a resolution mechanism. Its objective is to (i) quickly identify the trouble, (ii) stabilize the operations, (iii) transfer part or all of the business to an assuming institution –often through a bridge bank– and (iv) commence and conduct the liquidation of the institution. These steps will be achieved by means of the following measures and operations.[162]

a. The "Special –Extraordinary– Surveillance"

The decision of the Prime Minister places the financial institution under Special Surveillance. Since, by definition, the distressed entity will be "insolvent", the Special Surveillance will be of the "extraordinary" type described above, including the DICJ´s ability to conduct restructuring operations with court approval, its ability to force a change in management, and other powers exorbitant to an ordinary situation of mere control.[163] This automatic empowerment allows the DICJ to very quickly conduct the most urgent operations to stabilize the business and it is therefore to be commended. However, especially in situations of more severe deterioration of the

[162] The regulation of some of those measures is coincidental with that of similar or even identical measures envisaged for the distress of less systemic financial institutions, and which have already been described in earlier sections of this paper. Mainly, reference will be made only to the specificities of this particular case. The interested reader will thus have to refer back to previous section for a complete picture.

[163] See, Part IV.D.1.b.

financial status or of higher risk of contagion, the "Special Surveillance" is likely to give way quickly to a situation of complete removal of the previous management and full empowerment of the DICJ.[164] While under this regime, the financial institution may apply for –and obtain– a loan to avoid defaulting on debts that are related to systemically important operations.

b. Specified Management: The Adoption of Management Control by the DICJ

Anytime after the issuance of the Special Confirmation, the Prime Minister, may issue an "*Injunction Ordering Specified Management*", whereby the DICJ –and no one else [165]– is vested with the powers of management and disposition over the business and the assets of the financial institution (Art. 126-5 of the DIA). The decision will be adopted either if the bank´s management had proved to be extremely inappropriate, or if a lack of implementation of the necessary resolution operations could cause the cessation of the business or a default in the financial institution´s debts and obligations, which, in turn, could conduce to a severe disruption in the financial system of Japan. Following its appointment, only the DICJ will have the right to represent the financial institution, execute its business and dispose of its assets.[166] In its condition as representative of the troubled financial institution, the DICJ may be requested to submit a management plan, to provide information and materials, and even to conduct any special operations or take any measures as deemed necessary by the Prime Minister (Art. 126-8 of the DIA). The DICJ is expected to conclude its mission to transfer the business or adopt any other similar measure within one year, although, under certain circumstances, the period may be extended for another year. [167]

c. The "Specified Financial Assistance"

In a manner similar to the situation described in the cases of the financial assistance method, financial institutions that are party to a merger, etc. ("Specified Mergers, etc.": a split, a transfer of all or part of the business or the assets, or of the shares[168]), of the insolvent financial institution may request financial assistance ("Specified Financial Assistance") from the DICJ. [169] The type of assistance will depend on the type of restructuring operation to be executed, and will include money grants, loan or deposit of funds, purchase of assets, guarantee or assumption of obligations, the subscription for specified preferred shares and other capital instruments (shares, subordinated bonds, subordinated loans, etc.) or loss apportioning of claims related to the restructuring operations. The Specified Failed Financial Institution and the Specified Assuming Financial

[164] Art. 126-13 (4) and (5) of the DIA.

[165] The DICJ may, however, appoint a representative to conduct all or part of the management of the business of the financial entity (Art. 126-6 of the DIA).

[166] Although not strictly speaking one, the DICJ will be generally subject to the regulation of the financial administrator, with the differences included in Art. 126-9 of the DIA.

[167] Art. 126-10 of the DIA.

[168] Art. 126-28 (2) of the DIA, and see also, *supra* note 108 and its accompanying text.

[169] Art. 126-28 (1) of the DIA.

Institution jointly request authorization from the Prime Minister.[170] Once the authorization has been granted, the Specified Assuming Financial Institution may apply to the DICJ' for Specified Financial Assistance.[171] Given its systemic nature, *the amount of the financial assistance is not limited to the calculated amount of the payout method of deposit insurance*; further, if it is at any point justified, the parties to the restructuring deal may request additional financial assistance from the DICJ (Art. 126-32 of the DIA). In case no petition for financial assistance is received by the DICJ, and the execution of one of the said restructuring operations is essential to avoid the systemic risk to the financial markets, the Prime Minister may seek to mediate in order to find a suitable assuming financial institution (Art. 126-30 of the DIA). In any case, and unless from the onset there is one or more financial institutions apt and willing to assume the business, assets and systemic operations of the failed financial institution, the restructuring and resolution of the insolvent bank will be instrumented through a bridge bank, whose management and operation is assigned to the DICJ.[172]

d. The insolvency proceeding of the financial institution

Once the resolution of the bank has been fully executed, the remaining assets and liabilities will be handled though general insolvency proceedings, and, normally, the financial institution wound up to its extinction.[173]

E. Other Essential Elements of the Recovery and Resolution System

This section includes a description of a number of highly relevant rules that complement the recovery and resolution mechanisms included in previous sections. Most of these rules have been incorporated in the 2013 reform, although they do not necessarily relate only to the situations of special crisis management or resolution of the financial institution.

[170] Art. 126-29 of the DIA.

[171] Art. 126-28 of the DIA.

[172] In this regard, similar rules to the ones described in the previous section of nationally systemic financial institutions would apply, with some amendments. See, Art. 126-37 of the DIA.

In this kind of bank insolvencies, the main objectives of the bridge bank are to ensure the adequate flow of payments, the avoidance of runs and generally to stave off the risk of a disruption in the functioning of the financial system. In order for this to be achieved, the DICJ can provide a loan or a guarantee of obligations to the Specified Bridge Financial Institution, when the Institution requires funds necessary to ensure the smooth execution of its business or a guarantee of obligations arising from the borrowing of such funds by the Institution (see, Art. 98, as applied, *mutatis mutandis*, by Art. 126-38). The DICJ is expected to prepare and implement detailed guidelines, which are to be approved by the Prime Minister and made public. Art. 126-36(2) of the DIA.

[173] As to the proceedings used for the extinction of the entity, see, *supra* notes 50 to 53 and, specially, 141, and accompanying texts.

1. The Adoption of the Necessary Measures by the Prime Minister: a Residual Clause

Although the reach of the provision is to be tested in practice, the DIA seems to include a residual clause that would allow the Prime Minister (i.e., the Commissioner of the FSA, or Director-Generals of Local Finance Bureaus)[174] *to adopt any measures that are deemed necessary for the smooth implementation of the orderly resolution of assets and liabilities of a financial institution* (Art. 137-4 of the DIA). The more likely interpretation of this general residual clause is that it is confined to any measure included in the DIA, its subordinate legislation and generally those measures related to bank recovery and resolution included in the financial legal framework. But the powers to impose measures could not go beyond the said framework.[175]

2. The Provision of Loans to Satisfy Obligations Whose Default Could Cause Systemic Damage

The DICJ may provide liquidity to a systemic institution under Item (ii) specified measures to allow for the timely compliance with debts and obligations whose default could cause "severe disruption" in Japan´s financial system (Art. 127-2 of the DIA).[176] This type of financing may be requested at any time during the resolution process. In fact, the law expressly regulates the case where the failed financial institution is undergoing any of the general insolvency proceedings or a Specified Management situation. In these cases, the law states that the loans will be "deemed to have been provided prior" to the commencement of the general insolvency procedure (whatever its type) (Art. 127-2(3) of the DIA). This rule may have the effect of turning the DICJ´s liquidity loan into an unsecured claim, while, following the general classification of claims in insolvency proceedings, it would have been classified as a post-commencement finance and hence enjoyed priority over most other creditors (with the exception, in Japan, of secured creditors over the value of the collateral). Nevertheless, the rule makes sense from the point of view of insolvency law tenets. The reason why post-commencement finance generally enjoys priority is because it is a new debt assumed to the benefit of the collectivity of creditors; these new loans, however, would entail the full repayment of certain creditors (the counterparties to systemic obligations), not all creditors, and therefore the rule of the DIA is reducing –albeit not eliminating– the prejudicial effect of the new indebtedness to pre-insolvency creditors.

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[174] Art. 139(1) and (4) of the DIA, Arts. 39 and 41(4) of the Order for Enforcement of the DIA.

[175] A wider interpretation would be providing exorbitant powers to a public agency –even through the formal intervention of the Prime Minister– that would reasonably require express legal support (beyond a general clause).

[176] The rules to facilitate compliance with this kind of obligations follow closely the articles that provide protection to "settlement obligations" following the provision of financial assistance (Arts. 69-2 *et seq*. of the DIA).

3. Rules Concerning the Protection of Creditors in Restructuring Operations [177]

In cases outside the scope of the "Specified Confirmation" regime, the protection of the integrity and value of the business, and therefore of the collectivity of creditors, is achieved by the petition, in parallel to the banking restructuring and resolution measures, of general insolvency proceedings that could bring about a stay of executions. The regime to confront the distress of the larger systemic institutions only uses general insolvency proceedings at the latest stage, to liquidate the remaining of the institution one the restructuring operations have been completed. Before and until that moment, the financial institution is subject to a situation of "Special Surveillance" (or of direct management by the DICJ –"Specified Management" –). In order to offer further protection to creditors and to avoid damage to the orderly process of resolution of the failed institution, the DIA includes a number of rules that, with different scope and effectiveness, normally pertain in the realm of insolvency proceedings.

The first of these rules concerns the law´s express legal recognition of the DICJ´s right to request financial institutions which are creditors of the institution under special surveillance to refrain from exercising its right to collect from its debtor until the business is transferred or other measures are adopted that stave off the systemic risk posed by the distress of the financial entity under surveillance (Art. 126-14 of the DIA). The law, however, does not state if the request needs to be respected, or the consequences of its non-compliance. A sort of "voluntary" stay of actions – and, a fortiori of executions– seems to be created by this norm. Its efficacy remains to be proven, although the authority of the FSA could be a convincing argument (both in terms of *auctoritas* and, indirectly, of *potestas*).

[177] In cases of restructuring operations executed with financial assistance (be it ordinary or specified financial assistance), the transfer of the business and assets and liabilities of the ailing financial institution to an assuming one is facilitated by –initially– doing away with the need to obtain previous consent from the counterparty creditors to the claims assigned. The transmission of claims and contracts to assuming institution is a classic rule of general insolvency proceedings aimed at making rescue operations efficient (and even possible). It is based on the underlying idea that a creditor with a claim against an insolvent debtor may hardly be in a worse position if there is a change of debtor, since, by definition, the entity acquiring the business shall be in a more sound financial condition than the insolvent one (or it would not have been in a position to acquire the business in the first place). In the light of this, such transactions are protected and normal private law –privity of contract– rules are waived. Art. 131 of the DIA would seem to include similar rules. And yet, the article generates some doubts. If our understanding is correct, the lack of need for a consent of the creditor would only be initial: a period of time –no less than a month- would have to be provided for certain creditors of claims against both the failed institution and the assuming institution to object. In the case of claimants based on contracts with an anti-assignment clause, the opposition would entail the annulment of the claim transfer with retroactive effect. Ordinary creditors (with no anti-assignment clause) against the failed financial institution who have not been assigned to the assuming institution, but that can be damaged, are awarded a claim (the difference between the amount paid through distributions in insolvency proceedings and the amount to be paid if it were not for the business transfer or the restructuring operation) against the assuming institution (Art. 131(7)); creditors against the assuming financial institution who have been assigned to the assuming institution will have the right to a special guarantee or security or set up of a trust to protect its claim following the restructuring operation, so long as the said operation "is unlikely to be detrimental" to such creditors (Art. 131(8)). These measures would seem to constitute an overprotection of creditors.

A more clear rule –albeit in an equally complicated legal text– would seem to stem from Art. 126-16 of the DIA, whereby a prohibition is created for creditors to seize movable assets or credit claims that are in the process of being transferred to an assuming financial institution through a "Specified Merger" type of operation [178] (a merger, a split, or a transfer of the assets or the business in the context of the "specified" financial assistance process). This rule only applies to cases of insolvent systemic financial institutions – Specified Measure under Item (ii)). This –important– protection of the restructuring operation, thus, would not seem to be available for all other cases of recovery and resolution of financial institutions.

In line with these rules, the DIA includes a measure to prevent the commencement of general insolvency proceedings from interfering with the resolution process. However, instead of suspending the rights of creditors to petition, the Act gives the Prime Minister (i.e., the FSA Commissioner) the right to make the Court aware of the Special Surveillance situation, of any measure or information that deems relevant to decide the case, as well as to convey an opinion as to the timing and other coordinating matters that could be useful for the Court´s decision-making process (Art. 126-15 of the DIA).

Furthermore, the Prime Minister may order the financial institution under "Specified Confirmation" to retain assets in Japan to ensure the "*smooth implementation of its orderly resolution*" process (Art. 126-17 of the DIA).

4. Effect of the Commencement of the Recovery and Resolution Procedure on Financial Contracts

The global financial crisis triggered by the failure of Lehman Brothers showed the risks caused by the involvement of banks with derivatives, CDOs and generally financial contracts. In light of this, the FSB (in its Key Attributes) expressly recognized the need to create rules that provide consistency between the systems of bank recovery and resolution and the functioning of financial contracts. Particular attention was placed on the automatic effect that certain events of the bank recovery and resolution system could have as triggers of early termination, application of financial guarantees and other consequences that could cause a substantial damage to the failing institution (and hence to its depositors, its creditors and, especially, to the stability of the financial system). In 2013, the Japanese legislator, following the approach of the Key Attributes,[179] included new rules on the subject matter.

In summary, the Prime Minister may, for a time that deems necessary (and which will be made public), suspend the effectiveness of early termination and other similar clauses regarding financial contracts associated with the financial market or any other financial system in Japan to which the failed financial institution is a party or in a position equivalent to it. The time of

[178] See, *supra* note 168.

[179] The approach adopted by the FSA is also consistent with the amendments included by the EU countries, through the implementation of the EU Directive on Bank Recovery and Resolution, Arts. 69-71.

suspension shall be determined based on the time required to implement *"a business transfer or any other necessary measure to avoid the risk of severe disruption being caused to the financial system of Japan* [...]*"* (Art. 137-3(1) and (2) of the DIA).[180] No doubt the period of time may not be long (the Key Attributes refer to 2 business days). In the consultation process, the FSA expressed its view that the time ought to be determined on a case by case basis based on the concrete circumstances.[181]

V. THE COST OF RECOVERY AND RESOLUTION OF FINANCIAL INSTITUTIONS

One of the most important elements of any bank recovery and resolution system is the allocation of costs. Specially in the wake of the recent global financial crisis, when tax payers had to suffer the heavy burden of massive bail-outs, international financial institutions and the world´s biggest economies worked together to avoid similar situations in the future. Costs should be supported by the financial system, by the market, and only very exceptionally should public funds be used – beyond as a merely temporary and instrumental use–. Although Japan´s damage in the recent global crisis has been limited and mostly associated with global macro-economic reasons, the country has a recent history of bank failures in which public funds were used in large amounts.[182] These two circumstances provide the context for the current Japanese regulation on the topic. We shall divide the description of the system in three brief parts: the system of separate accounts; the system of contributions; and the use of bail in tools in resolution proceedings.

A. The System of Separate Accounts

The DICJ follows a system of separate accounts for each area of operation.[183] This mechanism, applied to the operations concerning the insurance function and the treatment of distressed financial entities, allows for the adequate identification of the restructuring and resolution operations. The Corporation runs a *General Account* (Art. 41 of the DIA), where its ordinary deposit insurance operations are recorded: insurance payouts and the provision of financial assistance up to the amount of the insurance payout cost are recorded; and it is nurtured with

[180] The rule needs to be completed with the special regulation contained in the relevant Cabinet Office Ordinance. The Art. 35-18 of the Ordinance for Enforcement of the Deposit Insurance Act provides that agreements "shall be transactions pertaining to goods with a quotation on an exchange or any other market quotation, or transactions equivalent thereto, whereby a Financial Institution or Financial Institution, etc. is a party." This would seem to cover OTC traded derivatives.

[181] See, http://www.fsa.go.jp/news/25/20140305-1/01.pdf (available only in Japanese), see also, Okamoto, Lai and Nomura [2014] p.3.

[182] See, generally, *supra* B. 2; also footnote 9 and the quotes therein. Further, see, Harada *et al*. [2015] p. 55.

[183] And separate sub accounts will be run by the DICJ based on the type of operations, as established by Art. 40-2 of the DIA.

insurance *premia* paid by all the financial institutions that participate in the deposit insurance system.

The DICJ also runs a *Crisis Management Account* (Art. 121 of the DIA), which keeps track of the "*measures against the financial crisis*", including capital injections and, especially, any financial assistance that is provided in excess of the "insurance payout method", which constitutes the measure of the insured obligations of the DICJ and, therefore, the limit to its ordinary insurance operations.[184] Any funds beyond the "payout" point exceed the initial actuary calculations and therefore require additional compensations. Furthermore, the Crisis Management Account also records operations undertaken as part of the actions against the financial crisis (Art. 102 of the DIA) and the orderly resolution system (Art. 126-2 of the DIA).

B. Shortage in the Crisis Management Account, Borrowing and Special Levy

The execution of operations to tackle a financial crisis or the resolution of a financial institution may generate a shortage in the *Crisis Management Account.*

The needs for financing of operations against financial crisis and bank resolution may be covered by the DICJ´s borrowing from private financial institutions or from the BOJ.[185] The DICJ may also issue bonds to raise the necessary funds to conduct its operations against the financial crisis of its insured entities.[186] The system is designed so that the shortage in the *Crisis Management Account* is covered by contributions of the financial institutions that form part of the deposit insurance system, in case of crisis management operations (Art. 122 of the DIA) or covered by special contributions in case of orderly resolution measures (Art. 126-39 of the DIA).[187] Hence, the financing beyond the insurance relationship is mutualized and allocated proportionally between the financial sector. The particular amount of additional *premia* to be paid is to be determined by the FSA Commissioner and the MOF yearly, and based on the specific needs and the situation of the crisis management account.[188] The said Authorities will determine a contribution key (rate) that each institution will need to pay to the DICJ and the time for the payment. The final amount will be also determined by the amount of each institution´s liabilities.[189]

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[184] The General and the Crisis Management accounts were created and regulated by the DIA, and are the ones directly relevant to the analysis of this paper. But they are not the only accounts run by the DCIJ. In total, the DICJ runs 8 accounts. The other 6 are: the Financial Revitalization Account, the Account for Early Strengthening of Financial Functions, the Financial Functions Strengthening Account, the Damage Recovery Distribution Account, the Regional Economy Vitalization Corporation Account, and the Revitalizing Earthquake-Affected Business Account. See, DICJ [2016] pp.63-68.

[185] Art. 126(1) and (2) of the DIA.

[186] Art. 126 (1) of the DIA. The amount of indebtedness of the DICJ is capped by the Cabinet Order.

[187] Arts.122 and 126-39 of the DIA.

[188] Art.123 (2) of the DIA.

[189] Arts.122(3) and 126-39(3),(4) of the DIA.

However, under special circumstances, the additional costs may be subsidized by the Japanese Government. According to Art. 125 (1) of the DIA, the Government may provide subsidies to cover for part of the costs required for the crisis management when not doing so may "*deteriorate significantly and it may cause an extremely serious hindrance to the maintenance of an orderly credit system in Japan or cause severe disruption in the financial market or any other financial system in Japan*". In other words, no immediate additional contribution will be levied if the financial system may be destabilized by it, a situation which is, precisely, what was tried to avoid with the restructuring and resolution measures in the first place. If, however, in the following year there is a surplus in the Crisis Management Account, it will be paid to the Treasury to compensate for the previous subsidies (Art. 125 (2) of the DIA).

C. Making Directly-Involved Stakeholders Accountable: the Bail-in Rule in the Japanese Framework

The Japanese recovery and resolution framework includes a limited recognition of the bail-in rules. The rule concerning bail-in applies only to the financial firms that are expressly determined by the relevant regulation.[190] The rule covers both the situation of financial crisis (Art. 102 of the DIA) and of resolution of systemic entities (Art. 126-2). It is somehow "concealed" in Arts. 102(3) and 126-2(4) of the DIA, where there is no express mention of the possibility –let alone the need– to write down the equity and subordinated debt regulated therein. The said norms state that the Prime Minister, upon giving "confirmation" or "specified confirmation" over a financial institution (i.e., commencing the financial crisis or the resolution processes), will "decide on the treatment" of the equity, capital instruments and subordinated debt. This is understood as the possibility to determine their write down, write off or conversion into equity. But this is to be decided on a case by case basis, with no ex ante determination, and it is only referred to equity and equity-like instruments that were issued or created contractually as "bail-in-able."[191]

The DIA has included no statutory bail in. Although nothing is expressly stated in the law against it, the legal silence could be interpreted as if neither the DICJ, nor the FSA or the Minister of Finance have the power to trigger a bail in of non-bail-in-able instruments, or against the contractual conditions for the bail-in set forth in the contract or in the issuance.[192] Related to the

[190] Arts. 102(3) and 126-2(4) of the DIA and Arts. 29-2-2, 35-2 of the Ordinance for Enforcement of the DIA.

[191] Because of the contractual nature of the instruments subject to bail-in, the triggers do not need to be at the level of insolvency. The contract itself shall determine the triggers.

[192] This seems to be the interpretation of the FSA, as expressly stated in the public consultation process that preceded the reform. See, Okamoto, Lai and Nomura [2014] p.3.

The Japanese authorities formal view on the subject is that they are able to achieve the economic objectives of bail-in by capitalizing a bridge institution to which functions have been transferred and by liquidating the residual firm via powers to separate assets and liabilities of a failed institution. See, FSB [2016b] p.37.

objectives of the bail-ín, and following the FSB´s Key Attributes, the FSA announced in April 2016 a plan to introduce a TLAC regulation in Japan, which would apply to its three globally systemic banks.[193] The document explains a model of procedures of orderly resolution under the single point of entry strategy for Japanese G-SIBs. Under the model, creditors of external TLAC eligible debt liabilities will absorb losses in case insolvency proceedings are started. Statutory bail-in would then, in effect, be achieved through insolvency proceedings.[194]

VI. DATA CONCERNING THE USE OF THE SYSTEM

The previous pages show that Japan boasts a complete and modern regulatory framework, as well as a wide and experienced network of institutions capable of preventing, grappling with and resolving the crisis of its financial institutions. Although Japan has undergone within relatively recent times some episodes of financial crises, the overhaul of the system that has taken place in the last decade and the absence of important cases in the closer past makes the data available of limited relevance to assess the current recovery and resolution system. Nevertheless, in this section we shall give notice of the main numbers, mainly related to the activity of the DICJ and its subsidiaries, and will offer a brief description of the three most relevant cases that have been solved though institutions and measures that either remain in place or closely resemble the current state of things.

A. Basic Data

The total figures are not a good reflection of the implementation of the current recovery and resolution system. As can be seen in the following graph, out of the 182 cases of financial assistance to banks since 1992, only 2 correspond to a time where the framework had been substantially amended, and none of the cases are from after 2011.[195]

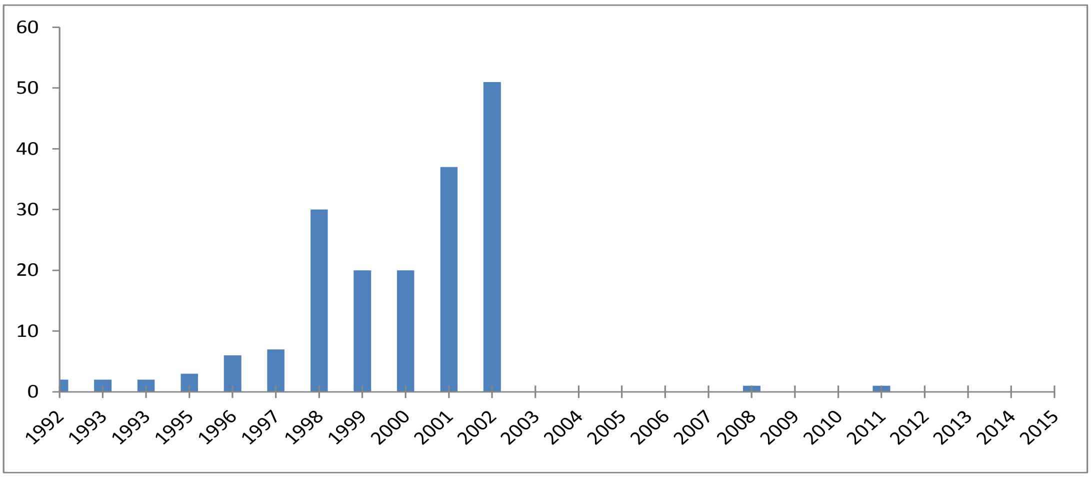
Related to the objectives of the bail-in, and following the FSB´s Key Attributes, the FSA announced in April 2016 a plan to introduce a TLAC regulation in Japan, which would apply to its three globally systemic institutions. See, http://www.fsa.go.jp/en/news/2016/20160415-1.html.

[193] See, http://www.fsa.go.jp/en/news/2016/20160415-1.html.

[194] See, FSB [2016a]. Note that the DICJ can inject capital to the specified bridge financial institution under Art. 126-35 (2) of the DIA.

[195] The restructuring framework for the financial sector was composed of a number of additional laws, amongst which the most relevant would be: (i) the Financial Functions Strengthening Act (in its version of 1998 (*supra* note 9) and the version of 2004 (*supra* note 47), which included special measures for the financial institutions affected by the Great East Japan Earthquake of July 2011), (ii) the Early Strengthening Act (*supra* note12) or (iii) the Organizational Restructuring Act (*supra* note 46).

Figure 6 Number of Cases of Financial Assistance



Source of data: DICJ [2016]

Since the implementation of the system of deposit insurance in Japan, the DICJ has provided financial assistance for over 48,292.2 billion yen. The allocation of the figure in the different types of financial assistance is as follows:

Table 2 Amount of Financial Assistance, etc. and Recoveries

(Unit: ¥ billion)

Financial assistance items	Financial assistance implemented	Cumulative amount of recoveries, etc.
(1) Monetary grants	19038.8	-
Of which monetary grants to the banks under special public management	6376.4	-
Of which monetary grants to the bank under special crisis management	256.4	-
(2) Purchase of assets	9830.6	10174.6
Purchase of assets from failed financial institutions	6535.1	7748.6
Of which the purchase of bad assets from the banks under special public management	1179.8	1660.0
Of which the purchase of assets from the bank under special crisis management	99.9	118.2
Purchase of normal assets from the banks under special public management	2942.1	1732.7
Of which the purchase of their holding shares from the banks under special public management	2939.7	1724.0
Purchase of assets from sound financial institutions	353.3	693.4
(3)Capital injection and participation	13045.5	13931.3
Capital injection	12386.9	13730.9
Capital injection under Former Financial Function Stabilization Act	1815.6	1739.3
Capital injection under Early Strengthening Act	8605.3	9763.3
Capital injection under Deposit Insurance Act	1960.0	2222.4
Capital Injection under Organizational Restructuring Act	6.0	6.0
Capital participation under the Financial Functions Strengthening Act	658.6	200.4
(4) Other	6383.2	5104.9
Taking over assets under the warranty for latent defect provisions	1222.6	677.2
Compensation for losses	576.7	-
Of which compensation for losses to the banks under special public management	494.7	-
Debt assumption (debt assumption to assuming financial institutions)	4.0	3.8
Lending	4579.9	4423.9

Source of data: DICJ [2016]

Most of the financial assistance programmes combined several measures. Out of the 182, only in one case the loan was the only measure; in 4 occasions, the purchase of assets was the single operation conducted; in 10 cases, only monetary grants were provided; while in 167 files, a combination of monetary grants and asset purchase was the chosen option.[196]

The recovery rates are very high. With the exception of the Monetary Grants, which, by definition are not to be returned, all other financial assistance measures have resulted in positive returns along the way (See, Table 2).[197]

In the case of Monetary Grants (by large, the most commonly used source of financial assistance), 10,432.6 billion yen were financed through the redemption of grant bonds provided by the Government of Japan to cover for the part in excess of the insurance payout cost (and hence were public funds). The rest was financed though the additional collection of insurance *premia* from financial institutions.[198]

B. The most relevant cases

Since the first case of financial assistance by the DICJ in 1991, many more followed during the 1990s. By then, neither the Japanese legal framework to tackle bank insolvency nor its institutional framework were developed enough. The system was slowly built up as bank insolvencies happened in the wake of the real estate bubble and the NPL crisis. The vast majority of the cases were then handled through relatively improvised solutions, with new and untested measures, and mainly using public funds: money grants, emergency loans, capital injections, etc. formed the battery of solutions that allowed the Government to slowly drag the financial economy out of its turmoil. It was not until the deposit insurance system was sufficiently funded, and a clear and modern system of rules was put in place that Japan was said to have an adequate bank recovery and resolution framework. Since that moment, with its landmark being the reforms implemented between 1998 and 2002, only three major cases have put the system to the test. The first two took place in 2003; the third, in the relatively recent year of 2011. In the following paragraphs, the main facts of those cases are described. They constitute, for the time being, the only example of how the system may work in real life.

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[196] Data is available at, https://www.dic.go.jp/shiryo/nenpo/h27/shiryo2-2.pdf (only in Japanese).

[197] The recoveries of purchased assets (bad loans) are mainly worked through the RCC, by means of sale and debt collection of the assets. The price of acquisition of the assets constitutes –evidently– the key to the recovery. The purchase of assets from problem banks must be made at an estimated market value. It has been estimated that the RCC has been buying bad loans at very large discounts: 78.2% to book value in the case of failed financial institutions, and at a 91.2% discount to book value when acquired from healthy financial institutions (see, Koo and Sasaki [2010] p. 9 and n. 17). The higher discount in the latter is probably due to the low probability of recovery of the loans (while troubled financial entities sell the bad loans in large amounts, healthy institutions do it more selectively with a view to clean up the balance sheet and make a surplus –even if small– from fully provisioned loans).

[198] The data, though, refers to the costs incurred in resolution cases of up to March 2003 (DICJ [2016] p. 31, note 3).

1. The case of the Resona Bank (2003)

It all happened very quickly with the Resona Bank, an entity of the Resona Group, then the fifth largest financial group in the country. In 2003, Resona Bank was created as a result of the merger of Daiwa Bank and Asahi Bank, two large but troubled banks, that a few years earlier had received substantive public funds through the issuance of subordinated debt and preferred shares subscribed by the Government. The financial condition of Resona was weak from the beginning. Its first fiscal year, losses had already accumulated to such a degree that the bank could be said to be balance-sheet insolvent were it not for the holdings of large deferred tax assets (hereinafter DTAs), large enough to keep not only solvent but even within the regulatory capital thresholds. In the first financial accounts, the auditors filed objections and refused to express a favourable opinion. Instead of seeking a recapitalization and formulating a viability plan, Resona Bank bet it all on the inclusion of DTAs in their calculations, which was the main concern of the auditor. A new auditor was appointed who adopted a different position, and allowed the bank to include three years worth of DTAs (as opposed to the five that the bank had included). This decision left Resona Bank under the minimum capital requirement.

On May 17, 2003, The FSA issued an order stating that the Resona Bank would be subject to PCA, as its capital ratio became less than 4% (barely above 2 %, which falls under "category one"), and, as a consequence, the institution had to apply for a recapitalization using public funds. On the same day, immediately after the PCA order and business improvement order (Art. 26 of the Banking Act) were issued, the FCRC was convened. It resolved that, with a view to avoid the destabilization of the financial system, 1.96 trillion yen in capital would be provided in application of Art. 102(1) of the DIA. Resona Bank issued 0.3 trillion equity shares and 1,66 trillion preferred shares, that were acquired by the DICJ framework. Allegedly, the shares were acquired at their market price.[199]

Resona Bank submitted a restructuring plan in June, 2003 to the FSA. The plan included the disposal of non-performing loans, a reduction in the credit activity and generally of the business, and continued to include a substantial amount of DTAs as capital. The management of the bank was replaced. The new management asked new auditors to analyze the bank´s financial situation. Pursuant to the content of the report, the new managers accounted a loss of 1.76 trillion yen only for the period between March and September 2003. In doing so, more than 90% of the capital provided by the government was written off. The losses included a large reduction in DTAs. The reexamination of the accounts proved that the Resona Bank was already insolvent when it applied for the capital injection.

An overview of the case reveals a number of possible problems in the implementation of the system. Firstly, the early detection system did not work adequately. The trigger of the crisis was the decision of the auditing firms to reject, first, and to partially modify, later, the financial

[199] See, Hoshi and Kashyap [2004] pp. 24 *et seq*.

accounts of the entities based on the treatment of DTAs as capital. Perhaps the supervisor ought to have been aware of it earlier. But the problems of supervision are more apparent considering that the bank was the result of the merger of two troubled banks, that had already been rescued with public funds. The "red alert" sign ought to have been beeping from the onset. Further, other criticisms are possible. While urgent action had to be taken and capital quickly injected, the final solution ought to have come following a detailed, justified viability plan. No mid to long term view as adopted. The other main criticism of the solution to the Resona Bank case was the overprotection of creditors. Not only depositors were protected, but other creditors, including holders of subordinated debt, were bailed out.

2. The Ashikaga Bank (2003)

There are similarities in the case of the Ashikaga Bank: a regional bank, it was also part of a larger financial group (the Ashigin Financial Group), and it had also received substantial public help in the 1990s. Its faltering business track record had been unimpressive for a number of years, and it suffered episodes of bank runs. The public support soon revealed insufficient. Preferred and ordinary shares were issued in 1998 and 2002. By the end of the Fiscal Year of 2002 (31 March 2003), the FSA found Ashikaga bank to be balance-sheet insolvent.

The bank was declared insolvent as under Art. 102(1)(iii) of the DIA, and hence subject to the "measures against a financial crisis" as regulated in Arts. 111 to 119 (and related) of the DIA. The DICJ stepped in and injected capital, effectively bailing-in shareholders and nationalizing the financial institution. The business continued to be operated by the DICJ, that complied with the ongoing and systemic transactions while slowly reducing the activity. In parallel, the DICJ was seeking an assuming financial institution. In 2008, Nomura Holdings (Japan´s largest securities firm) acquired the bank. Depositors were fully protected. No public money was used in the resolution process.[200]

While the execution of the bank resolution would seem adequate, again early detection mechanisms might have failed. On this occasion, it was not the DTAs, but rather the inadequate regulatory treatment of bad loans. The treatment of bad loans was and it might still be a concern in Japan nowadays. Then, and in the subsequent years, there was an alleged perception that banks held bad loans in larger amounts that they had actually let the FSA be aware of (the FSA inspection of Ashikaga Bank in the fall of 2003 uncovered 48 billion yen more of "doubtful" loans and 21 billion yen more of "uncollectible" loans than Ashikaga's own assessment.[201] Nowadays, as has been stated elsewhere in this paper, the openly lenient treatment of troubled

[200] DICJ´s insurance fund money was used: 1.7 billion yen in asset purchases and 260 billion yen in monetary grants. See, DICJ's News Release (available at, https://www.dic.go.jp/english/e_katsudo/e_shikinenjo/e_shikin-kisha/e_fy2008/e_2008.6.6.html).

[201] See, Hoshi and Kashyap [2004] p. 2. Interesting data on the Ashikaga Bank case can be found at Harada, Ito, and Takahashi [2010].

loans, thorough almost automatic rescheduling, may cast a shadow over the credibility of the balance sheets of banks.

3. The Incubator Bank (Nippon Shinkō Bank) (2010)

The Incubator Bank was a mid-sized entity established in 2003 whose main line of business focused on SME lending. Depositors were attracted through an aggressive commercial policy and it rapidly grew in assets, becoming dominant in one of Japan´s prefectures. The sustained low economic growth and its further slowdown as a consequence of the global financial crisis caused the bank to accumulate losses. An inspection by the FSA in 2010 showed a large amount of non-recorded NPLs. Soon after, the Incubator Bank suffered a rapid decrease in deposits and had no option but to declare itself unable to satisfy its claims.

On Friday 10 September 2010, the Incubator Bank formally notified the FSA its state of balance sheet insolvency under Art. 74 (5) of the DIA. Immediately after the notification, the FSA issued a disposition ordering the management against the Incubator Bank under Art. 74 (1) of the DIA, and a decision displacing the bank´s management and appointing the DICJ as financial administrator was adopted and publicized. Almost simultaneously, the Incubator Bank filed successfully for the commencement of Civil Rehabilitation. The Court opened the proceedings, issued a temporary restraining order over the business and assets of the bank and established the supervision of the entity. The definitive order of the Court took place on Monday 13 September. On Monday 13 September, the DICJ starts the implementation of the urgent decisions adopted by its Policy Board the previous day (Sunday 12 September), including an emergency loan to repay deposits and other relevant ongoing transactions. 16 locations reopened for business that Monday. During the coming weeks in September, over 100 locations had already reopened for business. Before the end of January 2011, the following had taken place: the purchase of assets (deposits and claims) is decided and executed; the management of the bank is changed, including the CEO; and the transfer of part of the business and certain assets by Japan´s 2nd Bridge Bank is underway. The Bridge Bank receives financial assistance for the operations, and the RCC directly purchases assets from the Incubator Bank (3 more rounds of acquisitions will take place in the following months). The search for an assuming banking institution is also underway. In July 2011, the Incubator Bank submits a proposal of a rehabilitation plan to the Court, and during the summer, the DICJ´s Policy Board adopts new decisions of financial assistance, given the more granular knowledge of the financial status of the bank. On 30 September 2011, AEON Bank is announced as the selected assuming financial institution. Creditors approve the Civil Rehabilitation plan in November that year, the Court confirms it and it becomes binding. The transfer of shares and assets from the bridge bank to the assuming financial institution is executed. Payments to creditors according to the Civil Rehabilitation plan (including to DICJ represented depositors) starts. The Incubator Bank is dissolved, liquidated and finally extinguished.[202]

The measures against non- nationally/globally systemic crisis envisaged in Art. 74 of the DIA were applied successfully, and, under the limited coverage scheme, uninsured deposits had to take losses. It would be the first time in Japan for decades –since the establishment of the DICJ in 1971– in which the uninsured depositors of a bank saw their claims written down. Allegedly, the solution served to underpin the current regulatory framework and helped reduce moral hazard in the banking sector.[203] Ultimately, no tax-payers money had to be lost.

VII. SOME REFLECTIONS ON THE JAPANESE BANK RECOVERY AND RESOLUTION SYSTEM

This section includes a brief general assessment of the current Japanese legal and institutional framework to deal with the distress of banks. It is followed by some reflections on certain areas of the system where possible risks have been identified and issues for possible debate have arisen. [204]

A. General consideration on the Japanese system

In line with its best international counterparts, the Japanese system of bank recovery and resolution seeks a triple aim: it tries to avoid the business and financial distress of institutions active in its financial market; it purports to maximize the value of the business and the assets of the troubled entities with a view to protect the interests of creditors, shareholders and other directly involved stakeholders; and, above all, its principal objective is to create the mechanisms that ensure financial stability, by protecting depositors, discouraging bank runs and cutting off the contagion channels. These three finalities are achieved through a compound of laws, regulations and institutions that can be assessed as *complete*, *up to date* and *adequately implemented.*

First, the system is *complete* because it: (i) offers coverage for all types of risks, from the ordinary risk inherent to businesses active in competitive market environments, to the systemic risks caused by problems in the financial sector, in the general economy or in the international dimension; (ii) it regulates the distress and insolvency of the different types of financial institutions (deposit- and non deposit-taking banks, holding entities of bank groups, foreign

[202] The timeline of events of the case has been taken from DICJ [2016] pp. 36-37. For a detailed legal description of the case, see Endo *et al*. [2013]. It is worthy of note that the dissolution was subject to FSA approval under Art. 37 of the Banking Act.

[203] See, Harada *et al.* [2015] p. 62.

[204] As stated at the onset of the paper, the assessment and the identification of the risks follow merely a desk review of the information available in English as well as the information I have been able to gather through interviews and research assistance. It is with these limitations in mind that the following sections are to be read.

branches, insurance companies or investment entities in the securities markets); (iii) it provides instruments to react in each stage of the financial risk, either before it materializes through prevention rules and practices, right after it is generated through identification mechanisms, or once it has been created, by means of its resolution measures; and (iv) it furnishes its resolution authority and implementing agencies with a wide array of instruments and solutions, stemming from capital injections or financial assistance, to more complex muli-front crisis management tools for troubled systemically relevant financial institutions.

Second, the system is *up to date* because it provides cutting edge, state-of-the-art techniques to prevent distress and to tackle it once it has happened, counting on an enabling legal framework beyond banking law that includes complex corporate law and business restructuring mechanisms as well as special solutions for internationally active institutions, in line with the standards endorsed by the FSB, the BIS and the IMF.

Finally, the system is *adequately implemented* because it benefits from an institutional framework that is highly qualified, well staffed and resourced and –as a positive externality from previous crisis– experienced in financial crises.

Besides, the above considerations are consistent with Japan´s high level of implementation of Basel III rules, and in line with the assessments received in recent years from international financial institutions.[205]

B. Topics for the Consideration of the Legislator

Despite the generally positive assessment of the Japanese system, an analysis of the details has shown elements that could perhaps be subject to improvement. They should be taken only as issues for discussion and paused but thorough consideration. The topics have been divided into those affecting the legal framework as a stand-alone factor, and those that concern material content of the recovery and resolution process.

[205] The Basel III Regulatory Consistency Assessment (level 2) of October 2012 (even before the improvements of 2013), Japan´s financial system was found to be "*compliant with the global standards agreed by the Basel Committee*" (report available at http://www.bis.org/bcbs/implementation/l2_jp.pdf). Concerning the degree of implementation of Basel III for G-SIFIs, a more updated assessment of June 2016 found the Japanese system equally *compliant,* in "Higher Loss Absorbency" and "Disclosure Requirements" (vid. http://www.bis.org/bcbs/publ/d371.pdf). The IMF´s Financial Sector Assessment Program´s Update of August 2012 (again, before some major reforms implemented in 2013) concluded that "[…] *important progress had been made since the 2003 FSAP assessment to strengthen and stabilize the financial system* […]". The IMF´s valuation, though, left some doubts open concerning certain aspects of supervision, capital requirements and bank resolution. Most of the issues concerning bank resolution were solved after the assessment. Others will be touched upon briefly in the next section. (the report is publicly accessible at https://www.imf.org/external/pubs/ft/scr/2012/cr12210.pdf).

1. Reflections on the Legal Framework

The legal framework for the system of recovery and resolution of financial institutions has been shaped through many years, without a defined pattern or strategy, but rather as a result of the emergencies dictated by market crises. Because of this, the regulation is neither orderly nor always clear and coordinated. It is at times complex for the non-versed interpreter to know where to search for the applicable rule to a given situation. The central point of the legal framework is the DIA, alongside which stands the Banking Act; but many of the rules are to be found only in *subordinate legislation*: in regulations, cabinet ordinances, enforcement ordinances or even in practice manuals. Some rules that would normally be considered as key to a regulatory system are not regulated in normative texts at law-level. While this has its positive effects, namely a greater flexibility and therefore an easier path to reform the system and adapt it to changes of the financial sector, it could be argued that the benefits are outweighed by its two main hazards: excessive flexibility undermines legal certainty, on the one hand, leaving highly relevant rules within the range of lobbies and political changes; and, on the other, it reduces public awareness –even by sophisticated operators in financial markets– and may increase transaction costs for possible investors. Just being able to know where to look for the rules in Japan would seem to require a considerable effort.[206]

Another hurdle in the way of the interpreter regards the very choice of the main law of the system of bank resolution. Most of the rules at a legal level are concentrated in the DIA. Naturally, the DIA, as a law that regulates mainly the corporation that runs the deposit insurance system, is essentially concerned with the setting up of the deposit insurance system and the protection of depositors. In other words, the whole recovery and resolution system of banks is presented from the perspective of the DICJ, when there are other actors and topics that do not concern directly the actions of the Corporation. The concentration of the regulation in the DIA would explain why, for example, there are hardly any rules that regulate the situation of creditors other than depositors; or why there is no coordination between the preventive remedies (to avoid bank failure) and the reactive remedies (to tackle bank failure); or why cross border issues are all but absent in the Law. Perhaps the Japanese system would benefit from a full, orderly, unified regulation, that covered the entire bank recovery and resolution system, from prevention to resolution, in one special law or, at least, in the general Banking Act.

[206] Although this is only marginally relevant, the problem would indeed be bigger for foreign investors and generally foreign stakeholders with interests in Japan´s financial markets. Many of the legal texts at subordinate legislation level can only be found in Japanese (this is not meant as a criticism, since, evidently, each jurisdiction should be obliged to publish their laws only in their own official languages; it is, rather, a reflection on how it poses a barrier to investment). Something may also be said about the legal technique used in some of the regulatory texts: a good example is the DIA, with articles which include thousands of words and dozens of internal referrals (to definitions, not always included in the article on definitions) and external referrals (to other laws and regulations). While high precision and repetition form part of Japanese legal drafting techniques, the banking regulatory framework goes much farther than the rest of the branches of the law that we have had access to.

Directly derived from some of the remarks made in the previous two paragraphs, perhaps one of the most salient legal problems of the system relates to the lack of coordination –and, in some cases, consistency– between bank resolution (i.e., banking law) and general insolvency law (both concerning its specific Japanese regulation and the subject´s globally accepted tenets). Although there are a few rules of coordination (for example, the DIA´s compilation and submission of the list of depositors to the Court conducting Civil Rehabilitation proceedings under Art. 463 of the Act of Special Treatment), more would be needed.

A few examples might help clarify this point. Firstly, in most corporate insolvency systems, there are two concepts of insolvency that give access to the insolvency proceedings: balance-sheet insolvency and cash-flow insolvency.[207] The DIA –the only legal text that regulates this topic– includes several different and inconsistent triggers or access-gates to the banking recovery and resolution system: it includes the concept of "failed financial institution", which is defined with reference to the suspension of the repayment of deposits, actual or "likely" (i.e., future and probable); in other words, a sort of "partial" cash flow test.[208] But deposits are not the only debts that a bank has, and therefore it is a poor proxy for the likelihood of a liquidity problem. What will happen if the bank has liquidity to repay depositors (under a situation of relative normality, with a normal number of requests, not under a bank run) but not its corporate bonds, or a syndicated loan? Or the salaries of its employees or tax duties? [209] Further, the DIA uses the "failed financial institution" concept as implying balance sheet insolvency in some parts of the law, generating confusion since the difference would not seem justified. To add to the confusion, the term "insolvency" is used –and used correctly– in the regulation of the right of set off, but a systematic interpretation of the law would not seem to allow its use as a tool for analogical interpretation beyond the very case of set off. The legislator may want to consider amending the

[207] In many modern legislations (i.e., Germany, Spain), a third category is established: imminent insolvency, which is in reality only a way to apply the general concepts of cash-flow or balance-sheet insolvency at an earlier stage. It is, thus, not a real new concept. Although not expressly labelled so, also Japan´s general insolvency law –e.g. Art. 21 of the CRA– would seem to include a mechanism of imminent insolvency, by allowing access to the proceedings when there is a "risk" of falling in one of the two general cases of insolvency.

[208] See, *supra* note 57 and its accompanying text.

[209] There are functional reasons for a financial system to offer protection to depositors: confidence in the system, avoidance of bank-runs, containment of contagion, etc.; but there is no justification to link the situation of insolvency –and even less the triggers for resolution mechanisms– exclusively with those debts. This type of rules might generate perverse incentives, altering *de facto* priority rules envisaged in the law, pushing the debtor to pay the creditors linked with the trigger, ignoring the rest. The rule, besides, does not truly protect the institution from suffering bank runs, since the lack of payment of employees, tax authorities or a syndicated loan would be considered serious enough to spark the crisis. This would be specially the case with banks and concerning large loans or bond issuances, since the consequences of a default –in terms of security rights/collateral or derivatives– would be all but incontrollable. Further, an insolvency system is aimed at solving the collective action problem created by the insolvency of all creditors, not of some of them.

law to unify the concept of insolvency.[210] Moreover, some of the articles place the entry gate to the system at a moment when it is too late, and the resolution system will probably be useless.[211] Because of this, the new trigger or access-gate to the recovery and resolution measures ought to be placed at an early stage. It would be what is generally known as the special "insolvency test" for bank insolvency: the "*regulatory insolvency test*". The triggers thus ought to be tied to the identification of certain levels of capital or, better, of liquidity requirements at an early stage.[212] Japan counts on mechanisms of early action. Consideration could be given to including a legal link between the PCA and the triggers for DIA measures.

A second example could be the –undefined, potentially problematic– relationship between the financial administrator (often, the DICJ itself) and the insolvency representative appointed in the general insolvency proceedings (a supervisor, a trustee).

As stated in section IV of this paper, the DIA confers upon the financial administrator (ex Art. 74) the most ample powers of administration and disposition over the business and the assets of the troubled bank. These ample powers of the financial administrator would seem to leave no space for another representative to act with regard to the operation and disposal of the business, its asset and the treatment of its liabilities.[213] More importantly, the relationship between the duties of the financial administrator and the stakeholders other than depositors in the general insolvency proceedings would seem unclear.

A first reading of the legal framework would seem to assign the "parallel" insolvency representative the task to protect creditors other than depositors, while the protection the depositors –ensured or not– would fall within the scope of the fiduciary duties of the financial administrator. In other words, the insolvency representative would pursue the protection of the legal interests of those creditors that would seem to fall outside the scope of protection of the financial administrator. However, this division of tasks merits further elaboration.

A literal interpretation of the DIA offers doubts as to whom does the financial administrator owe fiduciary duties. The DICJ is an entity generally tasked with the protection of insured depositors; any other act beyond the repayment of insured depositors is expressly included in the

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[210] In a very influential combined paper, the IMF and the World Bank expressly stated the importance of having a clear set of triggers, that allowed action at an early stage. See, IMF and The World Bank [2009].

[211] Even corporate insolvency law based cash-flow tests would seem to be inadequate to trigger bank insolvency at an early enough stage: see, Hüpkes [2000] pp. 12 *et seq*., *passim.* On this topic, see accurate the reflections of Lastra and Wood [2011] pp. 26 *et seq*.

[212] The EU Bank Recovery and Resolution Directive includes a flexible set of triggers (both for early action and resolution measures) that contemplates current shortages of capital and liquidity as well as shortages to take place in the near future. The probability that the shortage may occur in the "near future" is linked with a wide list of circumstances: a "deteriorating liquidity situation", "increasing level of leverage, non-performing loans or concentration of exposures", etc. (see, Art. 27 (4) for early intervention measures; for resolution, including the different classic insolvency tests –balance sheet, cash flow– and other impeding circumstances –also actual or potential–, see Art. 32 (4)).

[213] See, Part IV. B.3.

DIA and has been described earlier in this paper (subrogation in the position of insured depositors, protection of the rights of uninsured depositors within general insolvency proceedings, formation of the list of depositors, etc.); but beyond those tasks, and in the absence of a specific rule, the DICJ would not seem to owe a duty of loyalty (i.e., the protection of the interests of) to other creditors. The interpretation of the silence of the DIA in this direction would seem supported by the literal interpretation of the articles of the Act on Special Treatment concerning the DICJ's duty (Arts. 396, 467, and 508). For instance, Art. 396 states "*(1) The Corporation shall conduct the acts referred to in the preceding Article in a fair and sincere manner in the interest of Depositors Represented by the Corporation. (2) The Corporation shall conduct the acts referred to in the preceding Article with the due care of a prudent manager for Depositors Represented by the Corporation*". In other words, in the articles that regulate the duties owed by the DICJ under general insolvency proceedings, there is only mention to depositors, and it would seem difficult to derive a duty to protect the interest of any other stakeholder affected by the bank insolvency.

Thus, no express fiduciary duty –beyond the general tortious liability rule of not damaging third parties– links directly the financial administrator and the rest of creditors. And since the substantial ranking of claims of depositors and the rest of creditors is different (i.e., the fact that insured depositors are fully paid by the DICJ means that confers a prior status than the rest of creditors on the depositors and, therefore, the economic value of claims is also different), the interests of all creditors would not be aligned (since, in general, by definition, those upper in the ranking would benefit from a more conservative management and disposition of the business, and vice-versa). This might create problems in practice.

However, the foregoing interpretation is contradicted by the Japanese authorities as well as by its doctrine. It is widely accepted that the financial administrator would owe fiduciary duties to protect the interest not only of depositors (insured and uninsured), but any other creditor and stakeholder affected –and legally protected– by the DIA and related regulation. This position is grounded on the systematic, joint interpretation of Art. 77 (5) of the DIA and article 80 of the Corporate Reorganization Act. Art. 77 (5) of the DIA regulates the appointment and functions of the financial administrator, and states that Art. 80 of the Corporate Reorganization Act will apply "mutatis mutandis" to the financial administrator. Art. 80 of the Corporate Reorganization Act, literally, states: "*(1) A trustee shall perform his/her duties with the due care of a prudent manager. (2) If a trustee fails to have the due care set forth in the preceding paragraph, the trustee shall be jointly and severally liable to compensate damage to any interested person*". In other words, the combined reading of these two articles would reflect the existence of a general duty of care by the financial administrator.

In the eyes of a non-specialist in Japanese law, this argument would not be convincing, since a duty of care refers to the necessary conduct that must be observed to comply with a legal duty, but says nothing concerning in favour of whom such duty must be observed: hence, in case of conflict between different stakeholders, and/or in the absence of a specific norm that protects a particular stakeholder, neither article would be creating a justification for the financial administrator to protect the interests of creditors other than depositors. However, this is only an outsider´s view. It seems to be a non-controverted opinion (both by authorities and academia) that the ”duty of care” included in Art. 80 of the CRA is to be read as encompassing a “duty of loyalty” to all those stakeholders participating in a civil rehabilitation case (and, in the situation of a financial institution, such scheme would apply to financial administrators in the financial assistance of a troubled financial entity). In other words, its seems peaceful that “financial administrator” owe duties to protect creditors and other stakeholders, apart from depositors,[214] and the possible problem of interpretation described above would not exist (and does not, in accordance with Japanese doctrine, exist).

And yet, even if the most predominant interpretation of the system is that the financial administrator does owe fiduciary duties to all the stakeholders involved in the distress of a financial institution (and hence to creditors other than depositors), it remains unclear how such protection is to be structured and be made compatible with the protection of the more senior stakeholders (depositors). May the financial administrator adopt a decision that will benefit depositors at the expense of the rest of the bank´s creditors? A clarification of the duties of the financial administrator vis a vis stakeholders other than depositors would seem in any case appropriate.[215]

The DIA includes a good number of rules to facilitate restructuring operations. Since most of those operations involve a bridge bank and/or an assuming financial institution through a restructuring operation (“merger, etc.”, in the DIA terminology), exceptions to ordinary corporate law or to general private law are introduced. Two clear examples of these exceptions would be the rules that reduce the majorities necessary at a shareholders meeting for an approval of a structural restructuring operation (or its substitution by a court decision), or the rules that waive the need to obtain creditors consent when transferring claims or contracts. This type of rules are ordinary in the realm of insolvency systems. The exceptions are deemed justified given the special circumstances of the debtor (the bank), the existence of a large collectivity of creditors, and the limited damage that can be suffered by the counterpart. And yet, the DIA introduces these exceptions in a very shy manner: a capital reduction is expected from shareholders in case of

[214] We have only been provided access to the quotes of the Japanese authors in Japanese. Examples of this non-controverted interpretation can be found in Ito [2012] p.125.

[215] Art. 59-2(1) and (2) of the DIA, which regulates certain types of financial assistance –and which would be applicable in case of “confirmed financial assistance” (i.e., financial assistance provided in the context of systemic entities ex Art. 126-2 of the DIA) – foresees a mechanism to allow for the fair and equitable treatment of creditors of the failed financial assistance in cases where the operations undertaken to solve the crisis may have prejudiced them. This could happen when there is a transfer to an assuming institution of part of the business and the result of the operation would undermine the expectations of repayment of the creditors of the failed institution. In these cases, the failed bank and the assuming bank, jointly, may apply to the DICJ for assistance to ensure this situation is remedied. This mechanism could provide relief to the “fiduciary” problem described in the text. It is, however, very open and, surprisingly, left to the proactive petition of the banks involved in the operation (when it should be the rights of creditors not to be damaged beyond the losses derived from the financial situation of the entity and the application of the bail in rules and the ranking of claims).

capital injections ex Art. 102 (1) of the DIA, but, should they refuse to adopt it [216], the whole operation is suspended (the confirmation given by the FSA/Prime Minister is “rescinded”); and, while creditors are not given the chance to block a transfer of their claim to a third party, they may object at a later stage (and even creditors of the assuming financial institution are given instruments to improve their position under certain circumstances).[217] It is at least doubtful that such protective measures be justified. They offer an over-protection to creditors (who, after all, assumed a risk) that is not granted in the most modern corporate insolvency system (and, in this point, there seems to be no difference on the merits with the insolvency of a bank). In fact, it could be said that some creditors are given a windfall since, by definition, changing the debtor from an insolvent to a solvent institution would not seem, on the face of it, a detrimental operation to creditors. But this windfall may not come at zero cost. These operations may delay and even jeopardize the restructuring operations of banks that so much depend on their quick execution. Consideration could be given to revising this policy in the DIA.

2. Reflections on the Preventive Mechanisms

The brief description of the three cases in the previous section show that the preventive system did not work adequately. Although two of the said cases took place in 2003 and relevant improvements have taken place since, some of the reasons that led to the failure may persist. Special relevance could have the supervision of NPLs. Allegedly, the supervisor has not only allowed but also encouraged a lenient treatment of troubled bank debtors, especially in the case of small and medium enterprises. This policy would seem to have been replicated by the RCC. There have been –no doubt– powerful reasons to support the productive economy in times of slow growth and low demand. But a balance needs to be struck between a generous behavior on debtors and the need to ensure that the balance sheet of banks offers an accurate reality with regard to the valuation of its assets. This balance is difficult to achieve, but Japan´s supervisor might do well to have special care in this regard. The risk of “evergreening” loans could erode the trust in the system.[218] It would suffice to ensure that rescheduling and “second chances” are given only based on sound, carefully monitored restructuring plans; even if that implies an increase in the staff of banks and a therefore of its costs.

[216] Such refusal, however, would seem in practice highly unlikely, in light of previous experience. For example, considering that, in the Resona Bank’s case, the PCA and business improvement order were in place, and the bank had to return to well capitalized position as soon as possible.

[217] See, *supra* note 177 and its accompanying text.

[218] Watanabe [2006], based on evidence collected from Japan´s bubble crisis of the 1990s, found that strong regulatory measures, in times of crisis, may have the effect of increasing bank lending towards the weaker creditors (precisely with a view to avoid worsening the bank´s balance sheet). This risk could be avoided by further regulatory –and supervisory– action, ensuring that such lending behavior (lending and refinancing) is based on sound viable decisions. A similar analysis and conclusions, also based on the Japanese experience, can be found at Peek and Rosengren [2003].

Another risk that would seem relevant to the Japanese banking system is the valuation of public bonds. The portfolio of public debt in some financial institutions is proportionally so large that a prudent or conservative valuation policy might bring about an excessive financial burden. However, particular attention by the supervisor would seem advisable.[219]

On the regulatory front of the framework, there are two issues that would merit special attention:

The DIA includes several references to management improvement plans and generally to restructuring plans in the context of the different resolution operations. While in the most modern regulations of the EU, following the Bank Recovery and Resolution Directive, a large portion of the deposit taking institutions need to prepare resolution plans (similar to the "living wills" of the US practice), in Japan, only the three largest banks (e.g. the G-SIFIs, in line with the requirements of the FSB´s Key Attributes) are subject to the resolution plans prepared by the FSA under the FSA Guideline III-2-3-6-2 (2). The preparation of bespoke resolution plans is helpful *ex ante*, since it forces banks to design a strategy, to identify their weaknesses and provides supervisors with valuable information. These plans would be a very helpful instrument to devise a quick solution in case of financial distress, and would constitute the backdrop against which the already existing plans should be measured. A careful reading of the practice manuals and other regulations of the supervisor show that the approach of the FSA is not really too far from their European counterparts. Little or no legal changes would be necessary to generalize –or, at least, enhance the scope of application of– these resolution plans.

Perhaps the biggest shortcoming of the system on the preventive front concerns the PCA capital ratio thresholds. While the requirements to trigger PCA for international banks are in line with best international standards, those for domestic institutions (half of the capital thresholds of the international banks) would seem insufficient.[220] When triggers are so low, the system ceases to be preventive, and is no longer useful, since, by the time triggers are activated, the financial institution is already far too deep into trouble. Besides, the soft requirements for the smaller and localized entities may end up backfiring on the system: the Supervisor could feel compelled to strengthen supervision over the smaller banks, using up staff and resources that might be necessary elsewhere.[221] In any case, even Japanese financial sector authorities have data on the

[219] In fact, this was one of the recommendations of the IMF in its FSAP update of 2012: "[…] *enhancing the monitoring of systemic risks, including from financial institutions' exposure to Japanese Government Bonds (JGBs) and equities*".

[220] Again, the IMF´s FSAP Update report included the following recommendation: "*The authorities could strengthen their prudential framework, including* […] *raising capital requirements for domestic-oriented banks*".

[221] And, as stated elsewhere in this paper, regional and national but domestic banks constitute a large portion of Japan´s financial sector.

In Japan, all internationally active financial institutions have adapted to Basel III. The same cannot be said for the smaller banks yet. This is another reason why the gap between local and international firms seems to have grown bigger in Japan recently. In line with this, see, Harada *et al.* [2015] p. 54.

possible gap that might constitute one of the biggest risks for the financial system.[222] In any case, there seems to be a policy underway to foster consolidation of smaller local and regional banks. This would reduce the number of institutions and, therefore, the supervision problems caused by the low PCA capital level requirements. However, this type of strategy only works adequately when the consolidation takes place between solid enough institutions.[223]

3. Reflections on Other Especially Relevant Topics of the Resolution System

During the financial crisis of the 1990s, the use of public funds to rescue troubled financial institutions or to bail out their creditors was commonplace in Japan. In part due to the lack of a full bank resolution system, in part due to the urgency of protecting financial stability in a time of economic straits, the Japanese Government pumped public money to pay private stakeholders. Already at the time, this solution was questioned by the Japanese society and bore a political cost. Times changed, and the international financial crisis found Japan well prepared. Its improved micro-prudential regulation, its strengthened supervision and the existence of a well-funded deposit insurance system prevented the Japanese financial system from suffering as much as other developed economies. In this context, the insolvency of the Incubator Bank was solved successfully without cost to the Japanese tax-payers. No bail out was needed. This was –and is– in line with widely accepted current regulatory wisdom. Rescuing troubled financial institutions with public funds alters the ordinary functioning of the financial market, provides an undeserved windfall to some sophisticated stakeholders and creates perverse incentives to bank managers and investors (moral hazard). Following the publication of the FSB´s Key Attributes and in an environment of international homogenization of rules to contain banking risk, Japan introduced further amendments to its system of bank recovery and resolution. The 2013 reform, among other relevant changes, consecrated the "bail-in" as a rule, placing Japan at the forefront of the financial systems. And yet, some considerations might be relevant concerning the way the bail in rules have crystallized in the Japanese system.

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[222] Harada *et al.* [2015] p. 56, writing on the macro stress tests conducted by the BOJ in their annual Financial System Report, state: "[…] *the report shows that the financial system will be resilient to global recession or a moderate rise in the market yield (2 percentage points), while it warns that some banks, in particular regional banks, will be undercapitalized under an scenario in which both global recession and rising yield affect the balance sheet of financial institutions*". This would be consistent with the IMF´s assessment concerning the stress tests conducted in the context of the 2012 FSAP: "[…] *stress scenario 4 put regional banks at a greater risk than major banks, given that the former had lower capital ratios, larger credit risk and larger holdings of Japanese Government bonds*" (the scenario was a double dip recession with a loss of 100 basis points in yields).

[223] Some recent experiences show that the concentration of already troubled financial institutions only generate more troubled, larger Banks, that increase the risk of contagion to the sector and are more complicated to deal with at a resolution level. This has saliently be the case of the recent Spanish crisis, where the Government (and the Central Bank) promoted a policy of mergers of savings Banks that ended in the country´s rescue by the European Stability Mechanism and the almost complete disappearance of the savings Banks in the jurisdiction. A recent summary of the crisis in Spain can be read at Otero, Royo, and Steinberg [2016].

The bail-in regulation included in the DIA might arguably be too “shy”. The following are some reasons for such assertion:

Firstly, the regulation is “shy” in its most strict sense: it is “concealed” in two articles of the law that do not expressly incorporate the bail in rule, but simply state its possibility. Art. 126-2(4) of the DIA, for the “special confirmation” cases, and Art. 102(3) DIA for ordinary “confirmation” merely state that the Prime Minister shall “decide” on the treatment of instruments with contractual bail-in clauses as equity capital. No bail in rule then, only a possibility for the bail in to be decided. Further, the expression is so general (“decide on the treatment”) that even an attentive reader of the law might not understand such expression to include a bail-in rule at all.

The bail-in rule is limited, since it only applies to certain financial institutions that are previously defined in subordinate legislation (a “Cabinet Office Ordinance”). Moreover, the rule would only encompass equity instruments and debt securities which expressly incorporate a bail-in clause in case of “confirmation” or “special confirmation”. It is, thus, a purely contractual type of bail-in and restrictive with regard to the type of instruments that can be written down/off or converted into equity.[224]

And finally, the system is left to the discretion of the relevant public authorities. This no doubt provides the Japanese Government with a high degree of flexibility, but that would have to be at some cost.

While it cannot be said to be inappropriate, such a “shy”, limited and “discretionary” bail in system might have some problems.[225] Starting from the end, it may weaken the rule´s potential to tackle moral hazard, since bank managers (and, specially, bank main shareholders, since the managers will likely be removed anyway) could have a reason to believe their financial institution will be bailed out after all (and the problem with moral hazard for insolvent entities –in banking or in corporate crises– is that the worse the situation is, the higher the probability of a bail out). Additionally, the lack of certainty may also have its effects in market behavior. Market participants benefit from clear rules that allow them to adopt *ex ante* informed investment decisions. Excessive discretion might undermine the effect of the information provided on the Japanese banking sector in terms of risk assessment. A more clear and stronger bail-in rule, in line with those recently incorporated to the Member States of the Eurozone, might bring about some positive effects. At least consideration ought to be given to it.[226] Consideration could also be

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[224] As stated earlier, in accordance with the SPE strategy external TLAC will be written-down through insolvency proceedings.

[225] In reality, concerning statutory bail-in the discretion of the Japanese resolution authority is limited by the insolvency court’s competence to determine the debt write-down ratio, etc. As with other parts of the system, perhaps the biggest challenge for the Japanese resolution authority will be to execute orderly resolution measures in cooperation with court proceedings. The involvement of court, however, has its positive side: it adds accountability and transparency in the process of debt write-down.

[226] The banking rules in terms of early action, supervision, resolution and bail-in in the European Union are very strict. This can be explained by the structure of the Eurosystem and generally of the monetary union. In an area with a single currency and monetary policy, but with 19 different and relatively independent fiscal

given to enhancing the type of instruments that can be subject to bail-in, introducing a statutory bail-in system whereby the Japanese resolution authority, based *objectively* on the facts of the case, may determine which creditors shall take losses. A legal predetermination of those that will *not* be considered for write-downs could also add certainty to a system, while preserving a strong restructuring tool.[227]

These past ideas lead to a very relevant reflection on the relationship between *Government discretion* and the situation of the Japanese financial sector and its economy more generally. Not only in the case of the bail-in rule, but in the adoption of other operational decisions in the implementation of the recovery and resolution system, the Japanese authorities enjoy a wide discretion. The use of public funds, even if as an instrument or temporary vehicle to solve the financial distress of a bank, is an open possibility. There are good explanations for such an open and "public" approach. One, which is shared with other developed economies, is the large size of the financial sector in proportion to the size of the economy. Contagion must be avoided, since a general failure of the system could make the entire economy collapse very quickly. The second is the extraordinary large quantities of public bonds in the balance sheets of banks. Japan is the world´s largest public debt market; and its banks –including the smaller banks– are its main creditors.[228] In this context, the risk that a fall in Government bonds may have in the balance sheet

policies, the interest of the richer countries to restrain the possibility of risk mutualisation explains the inclusion of very strict rules, that impose tough controls by common institutions and stave off the risk of failure of financial institutions, specially those with systemic potential at a EU level. This situation is not the situation of Japan, and, therefore, the inclusion of more lenient policies would seem a normal choice. Japan does not need to straightjacket itself to the point of the EU countries; but perhaps a slightly "tighter" regulation could benefit the Japanese system and its participants.

[227] Again, this is the mechanism used by the EU resolution system: next to an enhanced power of the resolution authority to generally bail in claims (statutory bail in), certain claims are expressly left out of the scope of the resolution instrument. According to Art. 44 of the Bank Recovery and Resolution Directive, among other, the following claims cannot be subject to a bail in (i.e., to a write down by virtue of a decision of the resolution authority): covered deposits; secured liabilities including covered bonds; liability arising by virtue of a fiduciary relationship that are protected in insolvency; liabilities to institutions other than creditors of the same group with an original maturity of less than seven days; liabilities to employees, commercial or trade creditors, tax and social security authorities or deposit guarantee schemes. As it is evident, the claims that naturally form part of a general corporate insolvency hierarchy are excluded from the bail in power. This is surely aimed at protecting the ex ante ongoing value of the bank, to prevent operational problems, enhance legal certainty and to ensure protection for the more senior creditors.

However, not everything is transparency and ex ante legal certainty in the European Framework. The Directive also allows Governments, under special circumstances, to exclude certain –mandatorily– bail-in-able claims (i.e., subordinate debt) from the application of the bail in instrument (Art. 44.3 BRRD). The possible reasons for the exclusion are: its strict necessity and proportionality "to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions"; "to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets"; or when "the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in".

[228] As of March 2016 (data: BOJ, Flow of Funds), the structure of Japan´s public bond debt is as follows: The total outstanding bond debt of Japan´s Government adds to 1040 trillion yen, of which 966.7 trillion

of banks is only comparable to the damage that a general financial crisis would have in Japan´s public balance sheet. High discretion and ample possibilities for public intervention to tackle banking crisis seems thus a way to “harness” the system, to keep the dangerous domestic “loop” under control. In this regard, Japan has no match, and any attempt to tighten the model must be made with extreme caution.

Finally, the legal framework might benefit from a more detailed regulation of cross border bank insolvencies.[229] Beyond the general declaration of art. 137 DIA, and the cooperation following FSB activity for globally systemic financial institution, there is no express regulation to solve private international law conflicts that may arise in the insolvency of a Japanese bank (or in the insolvency of a foreign bank concerning decisions that need to be implemented in Japan). This has proven to be a complex issue in international insolvencies, one that may interfere with the orderly resolution of a bank with international elements.[230] Problems arise specially concerning the recognition in a foreign country of decisions of the relevant resolution authority to bail in certain claims that are subject to the law of foreign state. Naturally, this is by no means a problem of the Japanese system, but a more general Private International Law issue that ought to be solved at an international level.[231]

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yen (93%) is bond debt of the Central Government and 73.2 trillion yen (6.4%) of the Local Governments (Subnational bond debt). An analysis of the debt by holders shows that 82.2% of total public bond debt (82.5% of Central Government bond and 78% of Subnational bond) is held by Financial Institutions, of which the percentages of the holdings of total public bond debt by the different types of Financial Institutions are as follows: (i) Depositary Institutions, 23.7%; (ii) Insurance Companies and Pension Funds 26.6%; (iii) other 34.8%. Of the total public debt, 5.4% is held by Social Security Funds (Public Pension Funds), 9.6% by foreign investors (essentially Central Government debt –10.2% of its total–, since the amount of foreign investors with Japanese Subnational debt is marginal –0.5%); and the remaining 2.8% of the total public bond debt goes to “others.”

By way of comparison, the numbers of EU Member States concerning holdings by foreign investors are (source: Bruegel Database, available at http://bruegel.org/publications/datasets/sovereign-bond-holdings/): Germany (Residents 40.4%, Non Resident 59.6%, Domestic banks 23.5%); France (Residents 38%, Non Resident 62%, Domestic Banks 9%) or Spain (Resident 56.5%, Non Resident 43.5%, Domestic banks, 49.3%). The difference with Spain is explained by the country´s recent banking and sovereign crisis, that led foreign investors to sell their positions (although they are recovering them at a very high pace).

[229] Generally, cross-border bank insolvencies would be regulated by the Act on Recognition of and Assistance for Foreign Insolvent Proceedings.

[230] Even within states as legally integrated as those of the European Union, this type of conflicts have arisen recently. This is the case of the Portuguese bank Novo Banco, where an English court refused to recognise the central bank of Portugal's exercise of its bail in powers concerning liabilities governed by English law (see, Goldman Sachs International v Novo Banco, High Court of England, decision of 7 Aug 2015). A similar situation, involving an Austrian “bad bank” and German Courts, took place in the Regional Court of Munich in the “Bayerische Landesbank v Heta Asset Resolution”.

[231] The problem is limited for the Japanese direct interests. Since Japan´s bail in system is so restricted (affecting only those debts that have contractually accepted the bail in), it would seem very unlikely that a foreign court would reject the application of the Japanese Authority´s decision to write down claims in the context of a bank resolution. The situation is different, though, concerning the recognition of foreign bail in measures in Japanese regulated debts.

However, Japan´s FSA has amended its supervisory guidelines to secure G-SIB adherence to the ISDA

Universal Protocol and non-G-SIB counterparty adherence. By requiring Japanese G-SIBs to adopt the ISDA Universal Protocol not only with major financial institutions but also institutional investors (i.e., non-GIBs), the Japanese stay would be effective even under contracts of foreign law. http://www.fsa.go.jp/news/28/20160808-1.html (Japanese only).

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