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TECHNICAL NOTE ON FINANCIAL SAFETY NET AND CRISIS READINESS

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TECHNICAL NOTE

FINANCIAL SAFETY NET AND CRISIS READINESS

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by Atilla Arda and Cecilia Melo Fernandes (IMF) in the context of the Financial Sector Assessment Program (FSAP) in Japan, led by Mahvash Qureshi (IMF). It contains the technical analysis and detailed information underpinning the FSAP findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

BOJ	Bank of Japan
CCP	Central Counterparties
CMA	Crisis Management Account
CMG	Crisis Management Group
CMM	Crisis Management Measures
CSE	Crisis Simulation Exercise
DIA	Deposit Insurance Act
DICJ	Deposit Insurance Corporation of Japan
D-SIB	Domestic Systemically Important Bank
DTI	Deposit-Taking Institution
ELA	Emergency Liquidity Assistance
FCRC	Financial Crisis Response Council
FMI	Financial Market Infrastructure
FSA	Financial Services Agency
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
G-SIB	Global Systemically Important Bank
IAIG	Internationally Active Insurance Group
ICP	Insurance Core Principles
JFAs	Japanese Financial Authorities
JSCC	Japan Securities Clearing Corporation
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions
LAC	Loss-Absorbing Capacity
LLR	Lender of Last Resort
MCM	Monetary and Capital Markets Department
MOF	Ministry of Finance
NBFI	Non-Bank Financial Institution
NCWO	No Creditor Worse Off
ORM	Orderly Resolution Measures
PSP	Private Sector Purchaser
RLC	Resolution under Limited Coverage
RRP	Recovery and Resolution Plan / Planning
SIB	Systemically Important Bank
TLAC	Total Loss-Absorbing Capacity

EXECUTIVE SUMMARY

Japan has made progress in improving its crisis readiness since the 2017 FSAP, and the authorities are committed to make further enhancements that are needed. Notably, the authorities have introduced loss absorbing capacity (LAC) requirements, expanded the recovery and resolution planning (RRP) perimeter to some degree, set up the Recovery and Resolution Planning Office (RRP Office), and revised the RRP guidelines for banks and financial market infrastructures (FMIs). They have also continued with annual reviews and updates of existing RRPs, advanced the work in firm-specific crisis management groups (CMGs), contributed to the workings of international standard-setting bodies, and engaged in bilateral workshops with foreign counterparts. These improvements were built on a relatively comprehensive bank resolution regime, but hands-on experience with managing bank failures and financial crises is fading in Japan, while the financial system is evolving and getting more complex, putting a premium on accelerated and expanded crisis readiness efforts.

Better structured crisis readiness efforts are needed to ensure that the financial authorities can deliver prompt and effective resolution outcomes. Japan's resolution framework comprises three administrative regimes complemented by ordinary and modified insolvency proceedings. Each resolution regime allows for several resolution options with supporting resolution powers. Discretionary powers require policies to guide decision-making, supported by operational manuals, and further operationalized with firm-specific resolution plans. The authorities should continue to codify and regularly review and update their readiness efforts. Moreover, they should execute a multi-year interagency crisis simulations program for diverse failure scenarios, including fast-fail resolutions of systemic and midsize banks, and their concurrent failure. Presenting such a program as a strategic priority under the leadership of a high-level national committee could be a powerful communication tool. It is important externally to raise public awareness of the authorities' crisis readiness efforts, and it is important internally to ensure agency-wide delivery of prompt and effective resolution outcomes by involving all relevant staff in resolution training and crisis simulation exercises (CSEs).

The resolution framework should be further strengthened along several other dimensions. Consistent with international standards and guidance, the authorities should continue to strengthen the RRP regime for insurers and FMIs, prioritizing central counterparties (CCPs), including an orderly resolution regime for the latter. To reduce potential resolution costs for taxpayers, the authorities should introduce statutory bail-in powers with complementary creditor safeguards. They should also ensure that resolution strategies primarily allocate losses to shareholders and creditors, supported by policies providing transparency on the choice between the several resolution regimes with the Crisis Management Measures regime designated as a last-resort option. Internationally, the authorities should seek to further deepen cross-border cooperation and coordination arrangements for crisis readiness and management with key partner countries.

More banks should be subjected to RRP, supported by comprehensive planning guidance. Considering that the resolution framework applies to all banks, including potential (preemptive)

public financial support, and that the authorities estimate that several large deposit-taking institutions (DTI) hold substantially more insured deposits than readily available deposit insurance funding, it is critical that RRP requirements are gradually expanded to more banks. The authorities should first prioritize all Major Banks for recovery planning and all systemically important banks (SIBs) for resolution planning, eventually covering all banks that could be deemed systemic at the time of failure. Meanwhile, they should continue to comprehensively articulate their expectations of banks in improving recovery capabilities and addressing impediments to resolvability. Moreover, an expanded RRP perimeter should include requiring more banks to maintain a minimum amount of LAC, calibrated to each bank's resolvability needs. Expanded LAC requirements would improve resolvability and reduce the deposit insurance fund's (DIF) exposure, rendering potential resolution measures less costly for taxpayers.

Staffing resources and decision-making structures should be commensurate with further enhancements in the crisis readiness framework and the need to manage bank resolutions in an increasingly complex financial system. As the center of excellence for RRP at the Financial Services Agency (FSA), the RRP Office leads recovery plan reviews and resolvability assessments, develops pertinent policies and guidelines, and engages with foreign counterparts (bi/multilaterally; firm level). This broad work portfolio appears to leave the RRP Office staff stretched. The RRP Office's key role in the preparation of critical resolution decisions should be further strengthened with an enhanced resolution governance structure that allows for agency-wide integrated information flows and decision-making so that all relevant FSA staff can effectively contribute to undertaking speedy live contingency planning for an imminent firm failure. As the RRP perimeter expands, crisis readiness efforts intensify, international engagements deepen, the authorities could be exposed to implementation and reputation risk if staffing resources and decision-making structures were to prove insufficient.

Many aspects of the emergency liquidity assistance (ELA) practices at the Bank of Japan (BOJ) are robust, but some components of the ELA framework could be improved. The BOJ has sound guidelines for solvency requirements to provide ELA for prudential purposes and for operational disruptions (under Articles 33 and 37 of the BOJ Act, respectively). It can extend loans in foreign currency and has currency swap agreements with several central banks. The BOJ also undertakes annual reviews of eligible collateral based on market conditions. Yet, the ELA framework could be strengthened further in several dimensions. Increasing public disclosure of ELA eligibility, conditions, and procedures, could help to improve the ELA framework's credibility and accountability, and guide market expectations. In addition, the BOJ and the FSA should collaborate to strengthen ELA safeguards to reduce the likelihood of firms relying on ELA, thereby also mitigating potential moral hazard. It is also important to protect the financial soundness of the BOJ against potential losses arising from ELA operations. This could include making utmost efforts to request collateral as a first step when providing ELA under Articles 37 (operational disruptions) and 38 (financial stability concerns), and also implementing additional safeguards for extreme cases. Finally, the BOJ should consider expanding ELA eligibility to systemically important non-bank financial institutions (NBFIs), prioritizing CCPs given their pivotal role in ensuring the stability and efficiency of financial markets.

Table 1. Japan: Key Recommendations on Financial Safety Net and Crisis Readiness

Recommendations and Responsible Authorities	Timing*	Priority**
Resolution Governance		
1. Ensure staffing resources that are commensurate with increasing ambitions and with the need for preparing and managing bank resolutions in an increasingly complex financial system. (JFAs; ¶28–29)	C	H
2. Strengthen and operationalize the FSA governance for business-as-usual resolution work and for contingency planning for imminent firm failures. (FSA; ¶28)	C	H
3. Operationalize the FCRC's crisis readiness mandate particularly for policy setting and overseeing collective readiness efforts. (JFAs; ¶31)	I	H
4. Under auspices of the FCRC, execute a multi-year interagency crisis simulations program for diverse failure scenarios including fast-fail resolutions of systemic and midsize banks, and their concurrent failure. (JFAs; ¶26–27)	C	H
5. Review the PM's involvement in firm-specific resolution decisions to focus on cases where taxpayer money is at risk. (FSA, government; ¶30)	ST	M
6. Seek to further deepen cross-border cooperation and coordination arrangements for crisis readiness and management with key partner countries. (JFAs; ¶32)	C	M
Resolution Regime		
7. Subject more banks, prioritizing all Major Banks, to recovery planning requirements, supported by comprehensive planning guidance. (FSA; ¶20–21)	ST	H
8. Undertake resolution planning for more banks, prioritizing all SIBs, and continue to articulate expectations of banks in improving their resolvability. (FSA; ¶24)	ST	H
9. Require more banks, prioritizing all SIBs, to maintain a minimum amount of loss-absorbing capacity additional to regular capital requirements, calibrated to each bank's resolvability needs. (FSA; ¶33)	ST	H
10. Establish an orderly resolution regime for FMIs, prioritizing CCPs; continue to strengthen the RRP regime for insurers and FMIs, prioritizing CCPs. (FSA, government; ¶13, ¶22, ¶25)	MT	M
11. Introduce statutory bail-in powers with a NCWO safeguard; allow departure from *pari passu* treatment; establish depositor preference. (government; ¶18)	MT	M
12. Continue to codify and regularly review and update the authorities' individual and collective efforts to operationalize their crisis readiness efforts, the policies underpinning the several resolution regimes, and the supporting decision-making structures and information flows. (all; ¶16, ¶26)	C	M
13. Adopt principles and supporting policies to guide decisions on the use of official financial support in resolution, aiming particularly to impose losses primarily on shareholders and creditors, and to minimize taxpayer losses. (JFAs; ¶35)	ST	M
Emergency Liquidity Assistance		
14. Enhance ELA safeguards with additional (i) collateral requirements, (ii) lending conditions and (iii) other safeguards such as arrangements with the government to cover potential losses on ELA operations. (BOJ, MOF, FSA ¶42–44)	C	H
15. Increase public disclosure of ELA eligibility, conditions, and procedures to manage market expectations and support firms' readiness for prompt assistance at BOJ's discretion. (BOJ; ¶41)	C	M
16. Expand ELA eligibility to some NBFIs that could be systemically important, prioritizing CCPs. (BOJ; ¶45)	MT	H
Deposit Insurance		
17. Publicly commit to starting deposit pay-outs within seven business days after a bank's failure to increase depositor confidence. (DICJ; ¶47)	I	M
18. Regularly review and update the DICJ target level to achieve an appropriate level to ensure prompt payouts in case of a concurrent failure of the largest 2–3 non-systemic DTIs. (DICJ; ¶47)	M	M
19. Strengthen the DICJ governance by excluding active bankers from sitting on its Policy Board. (DICJ; ¶48)	I	L

* C: continuous; I: immediate (<1 year); ST: short term (1–2 years); MT: medium term (3–5 years).
** H: high; M: medium; L: low.

INTRODUCTION

A. Scope of the Assessment

1. This note sets out the analysis and detailed recommendations of the 2024 FSAP pertaining to the financial safety net and financial crisis readiness framework in Japan.[1] The note summarizes the FSAP findings, benefitting from the missions undertaken in September/October 2023 and January 2024, during which meetings were held with officials and senior staff of the FSA, the Deposit Insurance Corporation of Japan (DICJ), the BOJ, and the Ministry of Finance (MOF)—hereinafter together referred to as the Japanese financial authorities (JFAs). The mission also met with private-sector stakeholders, including banks, industry associations, and consultancy and law firms. The note considers developments since the 2017 FSAP, and it is based on the regime in place and the practices employed as of end-2023.

2. The FSAP analyzed Japan's financial safety net and financial crisis readiness arrangements.[2] It considered the domestic financial sector landscape, country-specific challenges, and international standards and good practices. The note focuses on the arrangements that apply to banks; it also touches upon some NBFIs, complementing the work of other workstreams part of this FSAP. While the note does not assess compliance with any standard, particularly two international standards and their assessment methodologies informed the analysis:[3] Key Attributes of Effective Resolution Regimes for Financial Institutions (KA) adopted by the Financial Stability Board (FSB);[4] and Core Principles for Effective Deposit Insurance Systems adopted by the International Association of Deposit Insurers.

3. The other technical notes that are produced by this FSAP cover the preconditions that international standards identify for effective bank resolution and deposit insurance. These include: (1) a well-established framework for financial stability surveillance and policy; and (2) an effective system of financial sector supervision, regulation, and oversight. The standards also call for a robust accounting, auditing, and disclosure regime, and a well-developed legal framework and judicial system—all of which fall outside the scope of this note.

[1] This technical note has been prepared by Atilla Arda (IMF, MCM, Financial Crisis Preparedness and Management Division) and by Cecilia Melo Fernandes (IMF, MCM, Central Bank Operations Division). The authors thank the financial authorities in Japan for the constructive dialogue and the many insights that they have shared.

[2] The FSAP did not assess the JFAs' business continuity planning that aims to ensure the continuity of their own operations, staff, and facilities when affected by external events, such as, a cyber-attack or an epidemic.

[3] Consistent with the methodologies, the FSAP did not have access to confidential firm-specific RRPs, and the FSAP made no judgment on the resolvability of individual firms.

[4] Most of the KAs apply not only to global systemically important banks (G-SIBs) but to any financial institution that could be systemically significant or critical if it fails—see, for example, Chapter IV of the KA Assessment Methodology for the Banking Sector. This includes the systemic importance of a domestic bank at the time of distress—not only in 'normal' times.

B. Japan's Financial System and Safety Net Members

4. Japan has a large and globally well-integrated financial system. Japan has one of the largest financial systems in the world with total assets nearly seven times GDP at end-2023. Financial groups have a significant presence in the financial system, and the four largest financial groups make up about one-fourth of total financial assets or about 170 percent of GDP. Banks play a dominant role in the financial system of Japan with the sector accounting for almost 60 percent of the financial system, with one-third of assets held by the three G-SIBs. The banking sector comprises city banks (including SIBs), trust banks, regional banks, Shinkin banks (credit unions), credit associations, credit cooperatives, and other banks (e.g., Japan Post Bank).[5] Japan's insurance sector ranks fourth in the world by total written premiums (in U.S. dollar terms) and accounts for 12 percent of the financial system. One of the three domestic CCPs, the Japan Securities Clearing Corporation (JSCC), is in the top-10 CCPs worldwide.

5. Bank capital ratios remain well above the regulatory minimum, and liquidity buffers remain high, but banking sector profitability has been weak.[6] Banks are generally well capitalized but have seen some recent decline in capital ratios due to valuation losses from overseas securities holdings and their risk weight densities have declined notably over the past decade. Nonperforming loan ratios have remained low and fairly stable since the pandemic. Banks have maintained sizeable JPY liquidity buffers, and about one-third of assets are liquid. Liquidity conditions among banks have been stable, with retail and insured deposits at 58 and 60 percent of total deposits as of December 2022. The decline in interest rates since 2016 have put downward pressure on banks' net interest margins and profitability, posing a challenge particularly for domestic banks and regional banks. The FSA has initiated measures to support the consolidation of regional banks to enhance their efficiency and preserve viability.

6. The financial safety net of Japan comprises three key members:

- The FSA is the lead bank resolution authority, supervises all sectors of the financial system, is responsible for bank RRP, and oversees the recovery planning by insurers and by one FMI (that is, JSCC). FSA staff is also the Secretariat for the Financial Crisis Response Council (FCRC) and supports the Minister of State for Financial Services.

- The DICJ is responsible for deposit insurance in the banking system, the execution of resolution measures, and liquidity and capital support in most resolution cases.[7]

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[5] The three G-SIBs are Mitsubishi UFJ Financial Group (MUFG), Mizuho Financial Group (MHFG), and Sumitomo Mitsui Financial Group (SMFG). Japan also has four domestic systemically important banks (D-SIBs) (Sumitomo Mitsui Trust Holdings, Norinchukin Bank, Daiwa Securities Group, and Nomura Holdings). The Japan Post Group accounts for about 12 percent and 22 percent of the banking and insurance sectors, respectively.

[6] See the FSAP Technical Note on Systemic Risk Analysis and Stress Testing for a thorough discussion of the structure and financial soundness of the financial system in Japan.

[7] The Agricultural and Fishery Co-operative Savings Insurance Corporation for agricultural and fishery cooperatives (including the Norinchukin Bank) falls outside the scope of this technical note.

- The BOJ is the central bank and lender of last resort, including ELA to banks and to some NBFIs, including in a few resolution cases.

7. Several committees provide a platform for coordination and cooperation among the JFAs and other authorities. Particularly, the FCRC advises the Prime Minister (PM) whether the resolution regimes for systemic cases should be triggered. The FCRC is chaired by the PM and comprises the Chief Cabinet Secretary, the Minister for State for Financial Services, the FSA Commissioner, the Minister of Finance, and the BOJ Governor. Other platforms—outside the scope of this technical note—include the Council for Cooperation on Financial Stability, the Financial Monitoring Council, the Working-Level Meeting on Macroprudential Policy, and the Joint Group for Coordinating FSA's Inspections and BOJ's On-Site Examinations.

C. Developments Since the 2017 FSAP

8. The JFAs are committed to continued enhancement of the RRP regime. Notably, they have introduced total loss absorbing capacity (TLAC) requirements that apply to four SIBs, expanded resolution planning to include one DSIB along with the three G-SIBs, set up the Recovery and Resolution Planning Office (RRP Office) at the FSA, revised the RRP guidelines for banks and FMIs, and introduced mandatory recovery planning by the JSCC. Meanwhile, they continued annual reviews and updates of existing RRPs, furthered the work in firm-specific CMGs for G-SIBs, contributed to the workings of international standard-setting bodies, and engaged in bilateral workshops with foreign counterparts. The JFAs intend to continue these efforts—at the time of writing this note, a public consultation is underway to expand resolution planning guidelines for banks with sections on testing and valuation capabilities. That said, the implementation of recommendations made by the previous FSAP has been mixed. This was due to (a combination of) staffing resource constraints (e.g., RRP perimeter), weighing potential benefits and legal challenges (e.g., statutory bail-in powers), awaiting more progress at the international level (e.g., FMI resolution regime), or a difference of views with the FSAP assessment (e.g., on DICJ governance and depositor preference).

D. Challenges Ahead

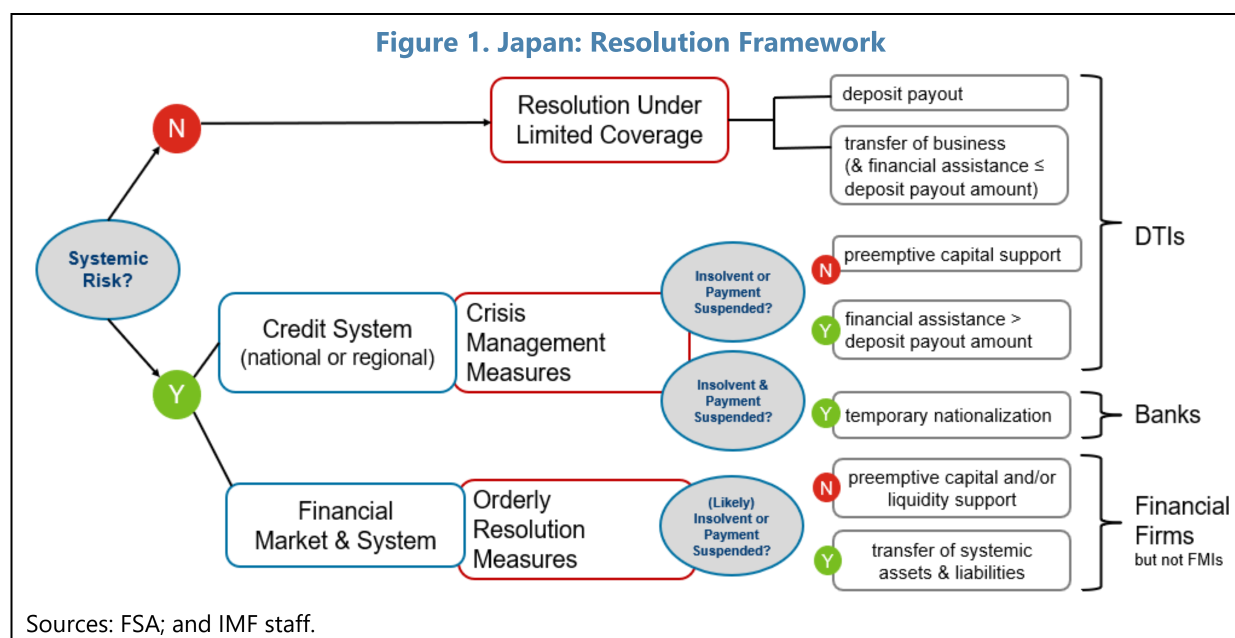
9. As in other countries, hands-on experience with managing bank failures and financial crises is fading in Japan. No Japanese banks has failed in over a decade, and it has been more than 15 years that an insurer in Japan failed. Moreover, unlike some other countries, Japan has not had near failures in recent years, thereby getting no significant opportunity for live-testing contingency planning procedures in a realistic setting. Therefore, the JFAs have not had a chance to build much needed “muscle memory” for crisis management. To the extent that crisis management experience was retained, one should acknowledge that this experience dates to the 1990s when Japan faced a severe banking crisis, while current financial systems and media landscapes are more complex, challenging, and international, and global good practices have evolved considerably.

WHEN FIRMS ARE FAILING

A. Three Resolution Regimes

10. Japan's resolution framework comprises three administrative regimes complemented by ordinary and modified bankruptcy proceedings (Figure 1). This framework has developed in several stages since the 1970s (Box 1). The framework distinguishes between deposit-taking institutions (DTIs), banks, and certain non-bank financial institutions (NBFIs). Furthermore, the framework distinguishes between failures in systemic and non-systemic situations. Each resolution regime allows for several resolution options with supporting resolution powers, which are laid down in the Deposit Insurance Act (DIA). Ordinary and modified bankruptcy proceedings for the rehabilitations, reorganization, or liquidations of financial firms would be overseen by courts.

Figure 1. Japan: Resolution Framework



Sources: FSA; and IMF staff.

11. In non-systemic events, DTIs would be subject to the Resolution under Limited Coverage (RLC) regime while modified insolvency proceedings would apply to most other financial firms. The RLC regime allows the DICJ to either transfer or payout insured deposits. The DICJ's preferred and practiced approach is to transfer insured deposits to either a private sector purchaser (PSP) or to a bridge bank. In non-systemic cases, the failure of most other financial firms, such as insurers and securities firms, would be subject to the Act on Special Measures for the Reorganization Proceedings of Financial Institutions, complementing the Civil Rehabilitation Act and the Corporate Reorganization Act.[8] The 'Special Measures Act' does not apply to FMIs, such as CCPs, which are solely subject to ordinary rehabilitation, reorganization, and insolvency proceedings.

[8] These rehabilitation and reorganization laws, in turn, complement the Banking Act and the Insurance Business Act. The latter two laws include pertinent powers, such as, suspension of a firm's business and revocation of its license.

Box 1. Japan: Evolution of the Resolution Framework

The Japanese crisis management and resolution framework underwent significant changes in the past five decades. Key milestones include the following.

- 1971: Enactment of the Deposit Insurance Act (DIA) and establishment of the Deposit Insurance Corporation of Japan (DICJ), with coverage limit of JPY 1 million.
- 1986: Amendment of the DIA to enable purchase and assumption transactions, as an alternative to insured deposit payouts. Coverage limit increased to JPY 10 million.
- 1996: Amendment of the DIA to introduce a temporary blanket guarantee on all deposits. Creation of the Resolution and Collection Bank during Japan's financial crisis, acting as assuming bank for failed credit cooperatives and empowered to purchase nonperforming loans from failed financial institutions.
- 1998: Introduction of new resolution powers with the Act on Emergency Measures for Revitalization of Financial Functions (Financial Revitalization Act), such as recapitalization with public funds, setting up bridge banks, temporary nationalization powers, and the appointment of financial administrators at failing firms.
- 2000: Amendment of the DIA, embedding powers under the Financial Revitalization Act (the so-called 'Measures against Financial Crisis').
- 2002: Amendment of the DIA to introduce full protection for deposits for payment and settlement purposes (effective as of April 2003).
- 2005: Outright abolition of blanket guarantees.
- 2013: Amendment of the DIA, introducing a new resolution regime for banks and nonbanks (so-called "Orderly Resolution Measures").

12. In systemic cases, Japan's resolution framework provides two distinct resolution regimes, depending on the type of financial firm that is failing and under what conditions. In the case of DTIs, the Crisis Management Measures (CMM) regime would apply, except for temporary nationalization which only applies to banks (excluding cooperatives). The Orderly Resolution Measures (ORM) regime would apply to banks and most other financial firms, including securities firms and insurers but not to FMIs.

- *The CMM regime* would apply if not taking the measures under this regime "may seriously hinder maintaining an orderly credit system in Japan or in a certain region" (Article 102 DIA).[9]
- *The ORM regime* would apply if inaction "may cause severe disruption in Japan's financial market and any other financial systems" (Article 126-2 DIA). The geographic scope does not distinguish between national and regional events, and the ORM regime has a wider functional scope as it would apply to a broader financial crisis (than distress in the credit system, under the CMM).

13. There is no FMI-specific resolution regime in Japan. All three administrative resolution regimes apply to banks, only the ORM applies to bank holding companies, securities firms, insurers; none of these regimes apply to FMIs. The KA1.2 requires that FMIs be subject to resolution regimes

[9] The FCRC considered regional effects in the Ashikaga Bank failure case (2003).

as appropriate to their critical role in financial markets, and in 2014 the FSB expanded the KA with specific guidance for the resolution of FMIs and FMI participants (KA, Appendix II, Annex 1). After adopting the FMI-specific standard, the FSB issued CCP-specific guidance on RRP in 2017 and on financial resources and the treatment of equity in 2020. However, in Japan, FMIs are solely subject to ordinary corporate rehabilitation, reorganization, and insolvency proceedings. Japan thus needs to introduce a resolution regime for FMIs consistent with pertinent international principles and guidance. Considering their systemic importance, the authorities should prioritize CCPs for this work.

14. The authorities are influential stakeholders in the insolvency proceedings for the rehabilitation, reorganization, or liquidation of most financial firms. These proceedings apply to banks, insurers, and other financial firms, but not to FMIs.[10] The FSA and the DICJ (as financial administrator) can petition courts for the commencement of rehabilitation and reorganization proceedings when a bank is likely to become insolvent or likely to suspend payments. They would also be able to seek a stay of proceedings that were petitioned by creditors. The DICJ would act on behalf of depositors and would typically be appointed as financial administrator where needed. The FSA can submit opinions throughout the proceedings, and courts must hear the DICJ about certain aspects of the proceedings (such as, the period for submitting claims). That said, courts play a significant role, including, with ex ante approval for certain resolution decisions, notably the use of transfer powers, but court procedures would typically not stay resolution decisions (that do not require court approval).[11] The JFAs should continue to be mindful of the courts' critical role and take this into account when planning resolution measures to ensure prompt execution.[12] The same applies to the courts' role in the recognition of foreign resolution proceedings.[13]

B. Resolution Measures, Powers, and Safeguards

15. Which resolution measures can be used would depend on whether the ORM regime or the CMM regime is followed.

- The CMM regime allows three types of measures: preemptive equity support ('item 1 measure'); financial assistance over and above a potential payout of insured deposits ('item 2 measure');[14] and nationalization ('special crisis management' or 'item 3 measure').

[10] On insurers, see the FSAP detailed assessment on compliance with the Insurance Core Principles (ICP).

[11] Pursuant to Article 27 of the Administrative Case Litigation Act, the PM can prevent a stay or cause a stay to be revoked. Relatedly, the JFAs advised that Japanese courts could reverse administrative decisions (such as resolution decisions) unless a reversal would be against public policy (such as financial stability considerations), in which case only monetary compensation would be the typical remedy.

[12] The valuation requirements under preparation are expected to also support court proceedings on resolution measures.

[13] This would follow the Act on Recognition of and Assistance for Foreign Insolvency Proceedings. This Act is based on the UNCITRAL Model Law on Cross-Border Insolvency. Arguably the Act applies to foreign administrative resolution proceedings.

[14] This amounts to a systemic risk exception for the least-cost test.

- The ORM regime allows preemptive equity and liquidity support ('specified measure I') and transfer powers for systemic assets and liabilities ('specified measure II').

16. A failing firm's financial condition is another factor in determining which resolution measures can be used. Under both the CMM and ORM regimes, preemptive equity support is permitted only if a firm is solvent at the time of a capital injection; the same applies to preemptive liquidity support under the ORM regime. Financial assistance under the CMM regime is available when a firm is insolvent or has suspended payments, while temporary nationalization—as a last resort—is only possible when a bank is insolvent and has suspended payments. Transfer powers under the ORM regime can be used when a financial firm is insolvent or likely to become insolvent or when a firm has suspended payment on its obligations or is likely to suspend payments. KA3.1 requires that entry into resolution should be timely and early before a firm is balance-sheet or cash-flow insolvent, or (likely to be) no longer viable.[15] Considering the difficulty to establish a firm's solvency in times of distress and the space for some discretionary judgment by the resolution authority under particularly the ORM regime—which is the broadest of the three resolution regimes—the JFAs should develop policies to translate this discretion in actions, based on the expectation that resolution will be triggered earlier than later and using the most flexible and comprehensive resolution regime.

17. The resolution regimes include broad supporting powers for effective resolution. The FSA Commissioner can appoint a financial administrator—typically the DICJ—to take control of a failing firm and help execute resolution measures, including by using transfer powers. The administrator/DICJ can take civil or criminal action against former or current shareholders, directors, or executives of a failed institution; with court approval, the administrator/DICJ can also remove and appoint the directors of the firm in resolution. Furthermore, if there is no PSP for a transfer transaction, the DICJ can establish and operate a bridge bank.[16] Lastly, under the two systemic resolution regimes contractual early termination rights and other actions that could pose a systemic risk can be suspended.[17]

18. Statutory bail-in powers are not available in Japan. KA3.5 requires that resolution authorities be able to, for example, write down equity and unsecured creditor claims or convert such claims into equity. Japan has opted for a contractual bail-in regime,[18] arguing that statutory bail-in powers require careful consideration of constitutional property rights consistent with restrictive legal precedent, while they can achieve similar economic outcomes by using the transfer powers under the ORM regime, imposing losses on equity holders and certain creditors by only transferring "systemic assets and liabilities." It should be noted, though, that Japan's constitution allows for

[15] See also the Essential Criteria and the Explanatory Notes for KA3 in the KA Assessment Methodology for the Banking Sector.

[16] See, for example, page 26 of the DICJ Annual Report 2022/23 for a discussion of the DICJ use of bridge banks.

[17] Although the JFAs advised that financial firms use contractual agreements to limit the duration of such stays on early termination rights, it should be noted that there is no set statutory limitation on stays, which is inconsistent with the KA4.3 prescribing that stays be strictly limited in time (for example, for a period not exceeding 2 business days).

[18] All AT1 and Tier2 instruments include contractual bail-in clauses.

"public welfare" exceptions to property rights with monetary compensation, provided that statutory safeguards are in place. Similar constitutional safeguards and exceptions exist in other jurisdictions where statutory bail-in powers were introduced successfully. Moreover, using transfer powers to impose losses on equity holders and unsecured non-systemic creditors will face additional challenges, such as due diligence, the costs of operating a bridge bank, and legal proceedings in the jurisdictions where the systemic assets and liabilities are located. In contrast, statutory bail-in powers would give prompt and less costly results. This should be complemented with no creditor worse off (NCWO) than in liquidation safeguards (KA5.2) and with the power to depart from the principle of equal (*pari passu*) treatment of creditors of the same class (KA5.1). Especially in the absence of depositor preference,[19] the latter would allow the authorities to better protect uninsured depositors in the interest of financial stability. The NCWO principle would better protect creditors, which could also mitigate any remaining constitutional concerns.[20]

PLANNING FOR FIRM FAILURES

A. Recovery Planning by Firms

19. All seven SIBs in Japan are required to prepare recovery plans with annual updates based on feedback from the JFAs. The authorities observed significant improvements in the recovery plans over several iterations with the first plans being developed in 2012. For the G-SIBs the plans are discussed in the CMG for each bank. For all SIBs, feedback letters are issued, identifying areas for improvement. Following that, the FSA and the BOJ hold meetings with the firms, after which the firms initiate changes to their organizations and the plans for the next annual cycle.[21] The review of firms' recovery plans is led by the RRP Office at the FSA (based on horizontal reviews) with input from the supervision teams and in consultation with the BOJ and the DICJ. In recent years, the authorities have not found critical shortcomings or impediments in the plans. The four SIBs that are also subject to resolution planning are leading the operationalization of recovery governance; the other SIBs are furthering their testing capabilities. The JFAs' focus is now shifting to the integration of the firms' recovery plans and their financial contingency plans.

20. More banks should be subjected to recovery planning requirements. Recovery planning is a key component of an effective RRP framework, aiming to provide firms with a regular mechanism to establish and maintain capabilities to restore their financial soundness when shocks materially affect their capital or liquidity position. The FSAP's assessment for banking regulation and supervision has concluded that the thresholds set out in the FSA's prompt corrective action regime remain calibrated to minimum capital thresholds and should be raised to allow earlier

[19] For the need of depositor preference, see IMF, The Case for Depositor Preference (2020).

[20] Under Japanese law, creditors can claim damages, but this is a general arrangement to receive compensation and be made whole. Japanese legislation for such claims does not specify a comparison with a counterfactual outcome under insolvency proceedings and therefore does not meet the NCWO requirements.

[21] The authorities reported that firms typically fully follow up on feedback within 1 or 2 planning cycles. So far, the FSA has not needed Business Improvement Orders to make banks comply with recovery planning requirements.

interventions.[22] This puts a premium on recovery planning by more banks so they can develop their own mechanisms to restore financial conditions at an early stage. For this expansion, the FSA should first prioritize all Major Banks that are not yet undertaking recovery planning.[23] Short of further expansion of (simplified) recovery planning requirements, other banks, such as the larger regional banks, prioritized by their risk profile, could be required to adopt credible, enhanced contingency funding plans—emulating recovery plans—subjected to the FSA's critical supervisory assessment. The foregoing would ensure proportionality in planning requirements considering each bank's structure, business model, and risk profile.

21. Banks need comprehensive recovery planning guidance. When more banks are subjected to recovery plan requirements, planning guidance should be improved. This will be particularly important for the banks that will undertake recovery planning for the first time. The section on recovery planning in the FSA 'Comprehensive Guidelines for Supervision of Major Banks, etc.' (Section III-11-2-2) only provides an outline for recovery plans without elaborating on the listed topics. At the time of writing this note, a public consultation was ongoing for testing and valuation capabilities, which the FSA intends to incorporate in the RRP section of the Guidelines. This will also help banks with recovery planning. The FSA should provide comprehensive guidance on more topics (for example, the Guidelines do not require a discussion of a bank's communications with internal and external stakeholders regarding its recovery process).[24]

22. The JSCC is also undertaking annual recovery planning. The JSCC has been doing so since 2018 on a voluntary basis following pertinent international principles and guidance, and since 2022 on a mandatory basis. With the revision of the FSA 'Comprehensive Guideline for Supervision of FMIs' in 2022, clearing organizations can be required to submit a recovery plan. So far, the FSA is only subjecting the JSCC to this requirement. The FSA and the BOJ engage in feedback meetings with the JSCC—without submitting formal feedback letters. The FSA's recovery planning guidelines follow the same approach as those for banks and will require updating with more guidance when the other two CCPs in Japan are subjected to recovery planning.

B. Resolution Planning by the Authorities

23. The FSA has prepared resolution plans for the three G-SIBs and one D-SIB. For each of these firms, a single point of entry resolution is the FSA's preferred resolution strategy.[25] Resolution planning is prescribed in the FSA 'Comprehensive Guidelines for Supervision of Major Banks, etc.'

[22] See the FSAP Technical Note on Selected Issues of Banking Supervision and Regulation.

[23] The FSA has designated the following nine Major Banks: Mizuho Bank; MUFG Bank; Sumitomo Mitsui Banking Corporation; Resona Bank; Mitsubishi UFJ Trust and Banking; Mizuho Trust and Banking; Sumitomo Mitsui Trust Bank; SBI Shinsei Bank; and Aozora Bank.

[24] For example, see other G7 jurisdictions: Bank of England Supervisory Statement on Recovery Planning; United States, Office of the Comptroller, Comptroller's Handbook.

[25] Under this strategy, losses in subsidiaries would be upstreamed to the parent company, then systemic assets and liabilities (including shares of material subsidiaries) would be transferred to a bridge bank, and bankruptcy proceedings would be opened against the parent company.

Several sections were included in 2018, detailing expectations of banks in improving their resolvability, including on operational continuity, liquidity monitoring, and loss-absorbing capacity (LAC). The FSA intends to add new sections on valuation and testing capabilities, for which a public consultation is ongoing. With deep dives, the FSA investigates impediments to resolvability, focusing on the feasibility of resolution execution and testing playbooks. For the G-SIBs, the plans and resolvability assessments are discussed in the CMGs for each firm. For all SIBs, feedback letters are issued, identifying areas for improvement. Then, the FSA holds regular meetings with the firms to discuss their progress in enhancing their resolvability. So far, the FSA has found these SIBs to be responsive to feedback.[26]

24. The FSA should prepare resolution plans for more banks. Considering that the resolution framework applies to all banks and includes potential public financial support, that the FSAP found vulnerabilities among regional banks and also concluded that more supervisory resources are needed to appropriately oversee regional banks, and that the JFAs estimate that several large DTIs, including also a few large regional banks, hold substantially more insured deposits than funding available in the deposit insurance fund (DIF; JPY 5.3 trillion),[27] it is critical that the FSA undertake resolution planning for more banks. This should be done gradually and proportionally, prioritizing first the remaining D-SIBs, so there is a resolution plan for all SIBs, then expanding further to the remaining Major Banks. Eventually, the FSA should undertake resolution planning for all banks that could be deemed systemic at the time of failure and therefore would potentially require applying the CMM and ORM regimes. In the meanwhile, the FSA should continue to articulate its expectations of banks in improving their resolvability and discuss with banks how their expertise and infrastructure would be used in resolution execution.

25. The FSA should undertake resolution planning for insurers. The four internationally active insurance groups (IAIG) are required to develop recovery plans, and the JFAs discuss these in the respective CMGs. However, there is no resolution plan for any insurer, despite the ORM regime being applicable to insurers, including access to potential official financial support.[28] The authorities should prepare for the resolution of an insurer, prioritizing the IAIGs, starting with the IAIG with predominantly life insurance business. The preparations should include manuals tailored to the insurance sector, firm-specific plans, and CSEs. For a detailed discussion of the Japanese framework for the market exit and resolution of insurers, see the FSAP assessment of Japan's compliance with the ICP.

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[26] If a firm would be unwilling to remove a material impediment to resolvability, the FSA can issue legally binding instructions to a firm pursuant to Article 137-4 DIA—if needed complemented with Business Improvement Orders based on the Banking Act—to change a firm's legal, operational, or financial structure, or its business practices.

[27] In fact, several DTIs hold insured deposits that are larger than even the higher DIF target level (that is, 0.7 percent of insured deposits—this level is capped at JPY 7 trillion).

[28] Moreover, in March 2022, the government extended (for another five years) the subsidy option for the Life Insurance Policyholders Protection Corporation with the following rationale: "the business environment surrounding life insurance companies is expected to remain severe" and "the government of Japan believes that it is necessary to extend government subsidies in order to appropriately protect policyholders under any circumstances and maintain the credibility of the insurance industry."

C. Operational Readiness Efforts

26. The JFAs have undertaken some efforts to enhance their operational crisis readiness. The FSA, together with the BOJ and the DICJ, organized a workshop with the three G-SIBs in 2022 and again in 2023 including the one D-SIB for which the FSA has prepared a resolution plan. As the JFAs continue to codify and regularly review and update their efforts to operationalize crisis readiness efforts and the policies and communication strategies underpinning the several resolution regimes, they should ensure that for each resolution option, there is a mutually complementary set of legal powers, translated into policy options to support informed discussions in the FCRC and decision-making by the PM and the FSA Commissioner, supported by operational manuals, and further operationalized with application strategies through firm-specific resolution plans.

27. The JFAs should execute a multi-year interagency crisis simulations program for diverse failure scenarios. There could be resolution measures that involve the FSA preparing the choice of measures, and the BOJ and/or the DICJ providing financial support. Therefore, it is important that the JFAs collectively can act promptly and effectively. This requires joint drills to ensure that all parts of the resolution framework can move together at the same pace in the same direction. Moreover, these collective exercises should include fast-fail resolutions of systemic and midsize banks, and their concurrent failure. These joint exercises could be preceded with agency-specific exercises and inform operational resolution manuals as these are developed. In any case, each agency should ensure agency-wide delivery of their respective contribution, which could mean that more staff will need to become familiar with manuals and be involved in the drills. A multi-year interagency crisis simulations program should be a strategic priority for the JFAs. Such external communications could be used to raise public awareness to the JFAs' crisis readiness efforts.

RESOLUTION GOVERNANCE

A. FSA Governance and Staffing

28. The FSA's RRP Office plays a positively critical role in furthering the RRP framework. As the FSA's center of excellence for RRP, the RRP Office leads recovery plan reviews and resolvability assessments, develops pertinent policies, guidelines, and manuals, and engages with foreign counterparts (bi/multilaterally; firm-specific CMGs). This broad work portfolio appears to leave the RRP Office staff stretched despite the increase of 5 staff since the previous FSAP, raising the number to 18 staff. The BOJ's Financial Stability Planning Group has less than 20 staff. For comparison, in fiscal year 2023, the DICJ had 427 staff. The RRP Office's key role in the preparation of critical resolution decisions should be further strengthened with an enhanced resolution governance structure that allows for agency-wide integrated information flows and decision-making so that all relevant FSA staff can effectively contribute to undertaking speedy live contingency

planning for an imminent firm failure.[29] As the RRP perimeter expands, the FSA should continue to seek opportunities to further strengthen the functional separation between RRP and supervision.[30]

29. Staffing levels and skillsets should be commensurate with an ambitious approach to enhance the resolution regime. In addition to the staffing concerns outlined above, many staff at the FSA and the BOJ are generally subject to a short-term rotation cycle, which could jeopardize retention of expertise. Furthermore, as the financial sector is getting more complicated and the RRP framework is maturing from policymaking to alternative approaches to planning and execution—with primary and backup plans—the JFAs will need to continuously assess the skillset and the number of staff that is needed for work that must be undertaken in 'normal' times to be prepared to act in times of distress promptly and effectively both domestically and internationally. Considering the foregoing and that RRP should be undertaken for more firms, the number of staff at particularly the FSA RRP Office and at the BOJ should be significantly increased. Without sufficient staffing, Japan runs implementation and reputational risks—especially considering that due to the difference in time zones with other major financial centers, the Japanese financial markets may at times be exposed to global financial turmoil earlier than their western counterparts.

B. The Government's Role in Resolution Decisions

30. The PM plays a large role in resolution decisions. Notably, the PM decides whether an event is systemic or not, determining the menu of resolution measures that can be used. The PM also decides which resolution measures to use in systemic cases. Both decisions are taken after FCRC deliberations. The PM is also responsible for suspending early termination rights and triggering contractual bail-in clauses, writing off AT1 and Tier2 instruments.[31] When the National Diet adopted the pertinent legislation, all of these powers were delegated to the FSA Commissioner. The DIA allows for delegated powers to be reassigned to the PM by Cabinet Order, which the Cabinet has done. To ensure the operational autonomy of the FSA as lead resolution authority, the involvement of political offices in firm-specific decisions should be limited to only cases where taxpayer money is at risk. This could be achieved by redelegating the aforesaid powers to the FSA Commissioner.

C. Domestic Interagency Cooperation

31. The FCRC is a platform where the JFAs could cooperate on crisis readiness and management. So far, the FCRC has been activated only in case of imminent banking failures and crises. The mandate of the FCRC is broad enough to include crisis readiness in addition to crisis management. The resolution policy and crisis readiness work discussed and recommended in this

[29] This is the same as banks' recovery governance arrangements, without relying on the usual decision-making structures for business-as-usual risk management.

[30] While both the RRP Office and the Banking Division I and II (supervising major banks and regional banks, respectively) report to the Director-General of the Supervision Bureau, they do so through different Deputy Director-Generals. Moreover, the Strategy Development and Management Bureau, which is responsible for the ongoing monitoring of the largest banks, reports to a different Director-General. For a discussion on the relationship between this Bureau and the Supervision Bureau see the FSAP note on banking regulation and supervision.

[31] Furthermore, the PM has the authority to license and to revoke licenses of banks and other financial institutions.

technical note could, therefore, be undertaken under the auspices of the FCRC. This would ensure high-level accountability and collective readiness in a more structured approach. The FCRC comprises officials at the highest level, which is understandable from a crisis response perspective. For the FCRC's crisis readiness work, a subcommittee could be considered. This subcommittee should also include the DICJ, which is currently not included in the FCRC. As the lead resolution authority that is already tasked with RRP and pertinent policy development, the FSA could chair this subcommittee. While the JFAs formalize their crisis readiness efforts as described above, they should continue existing informal and functional interagency engagements, such as between the FSA and the DICJ, the FSA and the BOJ, and more broadly in their preparations for CMG meetings. Collective crisis readiness work through the FCRC would not replace the existing cooperation on, for example, RRP, nor should it negate each agency's individual crisis readiness efforts.

D. International Cooperation

32. The international community appreciates the JFAs' active partnership in cross-border cooperation on RRP matters. For example, in addition to sectoral international standard-setting bodies (such as on banking or insurance), the FSA and the BOJ contribute to the workings of the FSB Resolution Steering Group and its subgroups, such as the Cross-Border Crisis Management groups. The JFAs spearhead—under FSA leadership—the work of CMGs that have been setup for the three Japanese G-SIBs and one D-SIB, supported by firm-specific cooperation agreements with relevant host authorities. The FSA and the BOJ also participate in the global and regional CMGs for nine foreign G-SIBs (headquartered in the United States, the United Kingdom, and Switzerland) with operations in Japan. In addition to these regular international engagements, the JFAs have some ad hoc international bilateral engagements, including bilateral workshops with foreign counterparts, which the FSA and the BOJ intend to continue. Considering the global interest in Japan's resolution framework and the JFAs' crisis readiness efforts, the JFAs should make more resources available to prioritize deepening their cooperation and coordination arrangements for crisis readiness and management with key countries regionally and globally.

RESOLUTION FUNDING

A. Banks' Loss-Absorbing Capacity

33. Japan's TLAC requirements apply to the four SIBs for which the FSA undertakes resolution planning. The requirements for external and internal TLAC were announced in April 2018 and introduced in March 2019.[32] According to the FSB's July 2019 "Review of the Technical Implementation of the Total Loss-Absorbing Capacity (TLAC) Standard," Japan's TLAC regime complies with the FSB TLAC Standard including certain exceptions provided therein. Some operational work on internal TLAC that was ongoing at the time of the FSB review has been completed (that is, the designation of material subgroups). The TLAC requirements apply to the three G-SIBs since March 2019 and to one D-SIB since March 2021. According to the JFAs, all four

[32] See the "Administrative Notice on criteria for total loss-absorbing and recapitalization capacity for bank holding companies pursuant to Article 52-25 of the Banking Act (Notice of FSA No. 9 of 2019)."

SIBs meet both external and internal TLAC requirements with no funding gap. More firms should maintain a minimum LAC in addition to regular capital requirements. LAC requirements should follow the expansion of the RRP perimeter, particularly including also banks with insured deposits over and above the readily available funding in the DIF. These requirements should be calibrated to each bank's resolvability needs.[33] An expanded LAC perimeter would improve resolvability and reduce the DIF's exposure, making potential resolution measures less costly for taxpayers.

B. Official Financial Support in Resolution

34. The choice of resolution measures determines the source of financial support in resolution. That said, the DICJ is the main capital provider, and it is the primary liquidity provider.[34]

- Capital support from the DICJ would render it (partial) owner of a financial firm. In the case of equity support under the CMM and ORM regimes, the DICJ would become a partial owner; full ownership would follow in case of nationalization.[35] The DICJ should develop policies and procedures to ensure that these shareholdings are managed at arm's length.[36]

- The three resolution regimes give the DICJ broad authority to provide liquidity support to firms in resolution, except in two instances where the BOJ would need to provide liquidity support to a DTI in resolution: item 1 and 3 measures under the CMM regime. In these cases, the BOJ may provide liquidity support at the request of the FSA Commissioner and the Minister of Finance, based on Article 38 of the BOJ Act. Before and after the resolution, firms can access BOJ facilities and ELA at the BOJ's discretion if they meet pertinent conditions. If the BOJ—based on the ELA Principles (see the ELA chapter below)—were to refuse a request under Article 38, the government would need to consider alternative resolution options.

- If funds at the DICJ are insufficient, it can borrow from banks or issue securities on the market. If speed is required, the DICJ can borrow from the BOJ—with a government guarantee—and funds would be channeled through the DICJ account at the BOJ. Such borrowing will always be necessary in case of capital support by the DICJ because such support would come from its Crisis Management Account (CMA). Although there is about JPY 367 billion in this account from resolution recoveries, the CMA is primarily an ex-post industry-funded resolution fund.

- DICJ borrowing from banks, markets, or the BOJ is capped at JPY 19 trillion for the General Account (that is, the DIF) and JPY 35 trillion for the CMA (that funds the measures under the

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[33] This is the practice in other major jurisdictions, such as the European Union (EU) and the United Kingdom (UK).

[34] For an overview of the DICJ funding program by accounts that it manages, see pp. 78–79 of the DICJ Annual Report 2022/2023.

[35] This happened in the cases of Resona Holdings (2003) and Ashikaga Bank (2003), respectively.

[36] See for example UK Government Investments and NL Financial Investments. (https://www.nlfi.nl/en/)

CMM and ORM regimes). If more funds are needed, funding would have to be obtained from the government with parliamentary approval.[37]

- The CMA could also borrow from the DICJ's General Account—that is, the DIF. However, considering the DIF level, borrowing from banks, markets, or the BOJ is a more realistic option. In any case, the DICJ should be very cautious in CMA borrowing from the DIF if this could leave the DIF financially vulnerable to honor its primary responsibility for deposit insurance.

35. To minimize taxpayer losses, the authorities should adopt policies for official financial support to firms in resolution. The fundamental principle under these policies should be the aim to undertake resolution without exposing taxpayers to loss (KA11.6) and that—in addition to ex post levies on the financial industry—losses are primarily allocated to shareholders and to unsecured and uninsured creditors (KA6.4). Although the DIA does not explicitly set protecting taxpayers as an objective for resolution measures, nothing prevents the JFAs from adopting said policies to guide future resolution funding decisions.[38] These policies could emulate the BOJ's ELA Principles and should ensure that resolution strategies primarily allocate losses to shareholders and creditors, supported by policies providing transparency on the choice between the several resolution regimes with the Crisis Management Measures regime designated as a last-resort option.

EMERGENCY LIQUIDITY ASSISTANCE

A. The Institutional Framework

36. The BOJ has the authority to function as a lender of last resort (LLR) by providing three types of lending for financial stability purposes under the Bank of Japan Act (BOJ Act). The LLR function aims to prevent the materialization of systemic risk by guaranteeing the access of liquidity to financial institutions that face shortage of funds with no alternative lending source. The types of lending that the BOJ may provide are (i) collateralized loans for prudential policy purposes (under Article 33), (ii) temporary uncollateralized loans for accidental causes resulting in an unexpected and temporary shortage of funds necessary for payment(under Article 37),[39] and (iii) loans under special conditions (hereafter "special loans"), which may also be provided without

[37] Although there does not appear to be an expedited appropriation procedure, the JFAs are confident that the regular budget procedures would allow for swift action if needed. Furthermore, Article 125 of the DIA authorizes the government to give financial support to the DICJ with ex post accountability toward the National Diet where ex post levies that the DICJ would need to assess from the financial industry could jeopardize financial stability.

[38] In fact, the Act on Emergency Measures for the Revitalization of the Financial Functions that introduced components of the CMM regime in 1998 before these were transferred to the DIA in 2000, explicitly noted that government interventions should minimize the cost of resolution measures and that bank shareholders and management should bear responsibility. Moreover, the 1999 report of the FSA Financial System Council on the deposit insurance system emphasized market discipline and creditors' contributions to minimize resolution costs.

[39] Accidental causes include earthquakes and cyberattacks. The BOJ provides ELA in such cases when it determines that these loans are necessary to secure smooth settlement of funds.

collateral, to maintain financial system stability (under Article 38). Table 2 summarizes the key elements of the ELA framework under each legislative provision.

Table 2. Japan: Key Elements of the ELA Framework

	Article 33	Article 37	Article 38
Type of loan	Funds for illiquid financial institutions with no other lending alternative.	Loans for temporary shortage of funds due to accidental causes and necessary to secure smooth settlement of funds among financial institutions.	Special loans when there is a strong likelihood that systemic risk will materialize, at the request of the government.
Extension period	Up to 3 months.	1 month (maximum).	Not pre-determined.
Eligibility criteria	Financial institutions that hold an account and a loan agreement with the BOJ.	Stipulated by law, encompassing deposit-taking institutions, securities companies, securities finance companies and money market brokers.	No constraints.
Collateral requirement	Same as of market operations.	None	None

Source: IMF staff.

37. Lending for prudential policy purposes in the context of ELA is an extension of the BOJ's regular business as outlined in Article 33 of the BOJ Act, which stipulates loans against collateral from the BOJ as a whole. It is usually granted at the BOJ's discretion for up to three months to solvent financial institutions that experience a funding shortage and lack alternative lending sources.[40] The eligible counterparties for Article 33 include banks and NBFIs that hold a current account at the BOJ and have entered into loan contracts with the BOJ. The collateral framework is currently the same as those of open market operations (see Annex I).

38. The BOJ may offer Article 37 temporary uncollateralized loans to financial institutions in response to unexpected shortage of funds due to accidental causes. The BOJ can extend the loans for up to a month when unforeseen shortages in payment funds arise due to accidental causes and the BOJ finds their loans are necessary to secure smooth settlement of funds among financial institutions. Such events encompass breakdowns in electronic processing systems, which can gravely disrupt business operations if the fund shortage is not promptly addressed. The conditions and the procedures are decided independently by the BOJ and are not publicly disclosed. The eligibility

[40] For example, in cases where capital requirements fall below the regulatory minimum, financial institutions may lose access to open market operations and to the complementary lending facility.

criteria are stipulated in a Cabinet Order and encompass DTIs including foreign bank branches, securities companies, securities finance companies, and money market brokers.[41]

39. In some specific cases, the BOJ may provide Article 38 special loans to maintain financial system stability, at the request of the FSA Commissioner and the Minister of Finance.[42] These special loans (known as *Tokuyu*) would be extended to institutions when the FSA Commissioner and the Minister of Finance deem that systemic risks may arise if such loans were not provided. These loans may be provided without collateral. The BOJ has no obligation to accept the request and its Policy Board independently determines the acceptability of such a request based on four guiding principles ('ELA Principles' for purposes of this technical note): (i) there must be a strong likelihood that systemic risk will materialize; (ii) there must be no alternative to the provision of central bank money; (iii) all responsible parties are required to take clear responsibility to avoid moral hazard; and (iv) the financial soundness of the BOJ itself should not be impaired.[43] The BOJ decides to provide such loans and determines the respective interest rates and procedures. However, Article 38 does not specify what type of institutions would be eligible, and an institution may not necessarily be solvent for the provision of such a loan. For the use of Article 38 ELA in resolution, see the previous chapter. Consistent with the ELA Principles, BOJ policies should explicitly limit Article 38 ELA to solvent institutions or to institutions that are expected to become solvent under a credible and timebound recapitalization plan.

40. The FSAP reviewed the BOJ's LLR function and the provision of ELA to illiquid financial institutions. Many aspects of the ELA practices are robust. In particular, the BOJ has sound guidelines for solvency requirements to provide ELA for prudential purposes (Article 33) and for accidental causes (Article 37) when financial stability concerns are imminent. The BOJ can also extend loans in foreign currency under an extraordinary situation where Japanese financial institutions face serious trouble in foreign currency settlements and are unable to resolve the situation by themselves, by utilizing (i) a part of its foreign currency-denominated assets (for US dollars), and (ii)currency swap agreements that were established and extended with four central banks in recent years (for the corresponding local currencies).[44] In addition, details on the collateral framework including the level of haircuts are publicly available. The latter is subject to yearly review and adjustment depending on financial market conditions.[45] Despite the robustness of the framework, there are some aspects where further enhancement would be beneficial, as outlined below.

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[41] Article 10, paragraph 1 of the Order for Enforcement of the BOJ Act, (only in Japanese) clarifies the eligibility criteria.

[42] The BOJ Act delegates the PM's authority to the FSA Commissioner, unless specified otherwise by Cabinet Order. The same applies to Article 37 temporary loans.

[43] These ELA Principles are detailed in Chapter VI of the 'Functions and Operations of the Bank of Japan.'

[44] Recent currency swap agreements include extensions of previous contracts with the People's Bank of China (October 2021), Reserve Bank of Australia (March 2022), Monetary Authority of Singapore (November 2022) and Bank of Thailand (March 2023).

[45] The haircuts are detailed in the BOJ Prices of Eligible Collateral.

B. Increasing Public Disclosure

41. The ELA framework can be strengthened further by increasing public disclosure about its eligibility criteria and conditions. Specifically, public disclosure on the solvency requirement and eligibility criteria of financial institutions could be improved by explicitly noting these in the English version of the published principles.[46] These disclosures could help to better guide market expectations and would further enhance the ELA framework's credibility and accountability.

C. Mitigating Moral Hazard

42. The BOJ and the FSA should collaborate to strengthen the safeguards to reduce firms' reliance on ELA. As per the BOJ's published ELA Principles, it is important to mitigate the risk of moral hazard. In this regard, the BOJ should clearly stipulate in the publicly available ELA guidelines that ELA under Articles 33 and 37 is conditional, discretionary, and granted basically at a specific margin above the policy rate.[47] Interest rates for ELA loans should be sufficiently high to motivate financial institutions to pursue alternative funding sources, yet not so high to exacerbate the financial pressures that ELA would aim to alleviate. In addition, financial institutions receiving ELA from the BOJ should be under the FSA and the BOJ's intensive monitoring and conditionality. For example, restrictions on the operations of financial institutions receiving ELA might be a viable approach, with the possibility of progressively tightening these restrictions if there is a lack of progress in repaying loans. To reduce the potential risk of moral hazard, it is critical that the general conditions and restrictions are made public.

D. Protecting the BOJ's Financial Soundness

43. When providing ELA under Articles 37 and 38 of the BOJ Act, the BOJ should make utmost operational efforts to request as much collateral as needed. These provisions allow an exception for uncollateralized loans. While the BOJ should retain flexibility in offering ELA under said provisions, it is imperative to protect the BOJ's financial soundness—as per the BOJ's own ELA Principles—by requesting as much collateral as needed. To help achieve this objective, the BOJ should implement an operational approach to support firms' preparations to ensure and enhance the mobilization of collateral. This approach could include conducting ELA simulations with the eligible firms. In addition, the BOJ could consider accepting a wide range of collateral at its discretion.

44. For exceptional cases of un(der)collateralized ELA under Articles 37 and 38 of the BOJ Act, the authorities should implement measures to safeguard the BOJ balance sheet. Providing ELA with un(der)collateralized loans could impair the financial soundness of the BOJ if a borrowing institution fails to repay the loans. Safeguarding the BOJ balance sheet could be achieved with, for example, a preferential status for the BOJ in the creditor hierarchy and arrangements with the

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[46] The solvency requirement for Article 33 is included in the BOJ's public guidelines but only in the Japanese version.

[47] An exception could be for the interest rates charged for ELA under Article 37 of the BOJ Act, as operational disruptions are distinct from liquidity management failures.

government to cover potential losses on ELA operations. Such arrangements could include provision and fully suspending or partially reducing the distribution of profits to the national treasury,[48] thereby allowing the BOJ to strengthen its reserves that can be utilized to cover potential future ELA losses. Importantly, it needs to be ensured in all circumstances that none of the measures, in any way, undermine the BOJ's discretionary powers. Requesting collateral is essential for robust ELA practices and should be the primary consideration before implementing additional safeguards.

E. Expanding ELA Eligibility

45. The scope of institutions eligible to receive ELA should be further expanded to systemic NBFIs, prioritizing CCPs. In principle, a wide range of firms is eligible to receive ELA under the BOJ Act, but key systemic NBFIs are currently ineligible. Therefore, the BOJ should further expand the coverage of NBFIs under Article 33 to access ELA for macroprudential purposes to those systematically important, in particular, to CCPs, given their pivotal role in ensuring the stability and efficiency of financial markets.[49] While the BOJ could grant ELA to the counterparts of a CCP, emergency liquidity provision directly to a CCP could be a more cost-effective and efficient way to prevent contagion and mitigate systemic risks in a timely manner, when a CCP itself is the source of the liquidity problem in the system.

DEPOSIT INSURANCE

46. The DICJ estimates that about 63 percent of deposit amounts and the balance of 98 percent of accounts is insured. The industry-funded DICJ protects general deposits up to JPY 10 million (about USD 67,000) plus interest, per depositor, per bank.[50] Overseas branches of Japanese banks and branches in Japan of foreign banks are not covered. The coverage includes most deposit types, except, for example, foreign-currency deposits, offshore market accounts, anonymous accounts, and deposits from the BOJ and insured institutions. A 2022 survey concluded that 60.5 percent of the population is aware of deposit insurance. The DICJ should continue its public awareness efforts to further increase this percentage, ensuring gender and generational balance.

47. In 2022, the DICJ Policy Board increased the target level of the DIF from JPY 5 trillion to 0.7 percent of insured deposits capped at JPY 7 trillion. Insurance premiums are determined by the Policy Board, with the aim to ensure the DICJ's long-term financing needs are sufficient to meet estimated expenses. Changes in the premium rates require authorization from the FSA Commissioner and the Minister of Finance. On the advice of a Study Group, including external experts, the DICJ replaced the absolute target level of JPY 5 trillion with a target ratio of 0.7 percent,

[48] See for example practices at the German Bundesbank in 2020 and 2021.

[49] It is internationally accepted that in principle all CCPs are systemically important at least in their own jurisdiction. Given its importance for financial stability, several central banks have arrangement to provide ELA or access to standard operations to CCPs, such as Bank of England, the Federal Reserve Board, Bank of Canada, Swiss National Central Bank and the Sveriges Riksbank.

[50] So-called "deposits for payment and settlement" (i.e., deposits that bear no interest, are payable on demand, and provide payment and settlement services) enjoy unlimited coverage.

which is expected to translate to about JPY 7 trillion in fiscal year 2031. In determining the new target, the DICJ considered past funding experiences and recovery rates, and expected deposit growth.[51] Currently, the DIF holds about JPY 5.3 trillion (about 0.6 percent of insured deposit). Considering potential recoveries in determining the target level makes sense from a financial soundness perspective. It is equally important, though, to consider immediate outflows in the few weeks and months after the failure of a DTI, especially as the international aspiration is to start payouts within seven business days after the failure of a DTI.[52] From this perspective, neither the current funds nor the target level is anywhere close to cover payouts if the largest DTI for which there is no resolution plan nor the largest non-systemic DTI would fail. Ideally, the DIF should hold enough funds to cover prompt payouts if the largest 2–3 non-systemic DTIs would concurrently fail. The DICJ plans to undertake an interim review of the target level in about five years. At that time, the DICJ should consider the (expanded) RRP perimeter when determining if a new target ratio or higher cap is needed.

48. The DICJ Policy Board is a key decision-maker within the DICJ. The Board comprises he Governor, up to four Deputy Governors, and up to eight non-executive external members. Currently, the Board counts the maximum number of 13 people, including 5 active bankers. The Board has general powers, such as deciding on the DICJ budget, funding plans, and insurance premiums—all of which are subject to approval by the FSA Commissioner and the Minister of Finance. Although, fundamental resolution decisions are taken by the PM and the FSA Commissioner, the DICJ Policy Board decides on many aspects of the execution of firm-specific resolution measures, including decisions on several aspects of deposit payouts, financial assistance, lending, and capital contributions. Consequently, active bankers are involved in market-sensitive resolution decisions. To effectively address this issue, active bankers should not sit on the DICJ Policy Board. As their tenure is just one year, the DICJ could have a board without active bankers within a year.[53]

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[51] Based on these considerations, the DICJ concluded that the JPY 7 trillion DIF cap should be sufficient to address the concurrent failure of several large regional banks.

[52] While transfer of business is a time-tested and cost-effective resolution option, one cannot rule out the need for payouts (if transfer of business cannot be done as recent experiences in other jurisdictions have demonstrated). To strengthen depositor confidence, the DICJ should publicly commit to starting payouts within seven business days after a DTI fails.

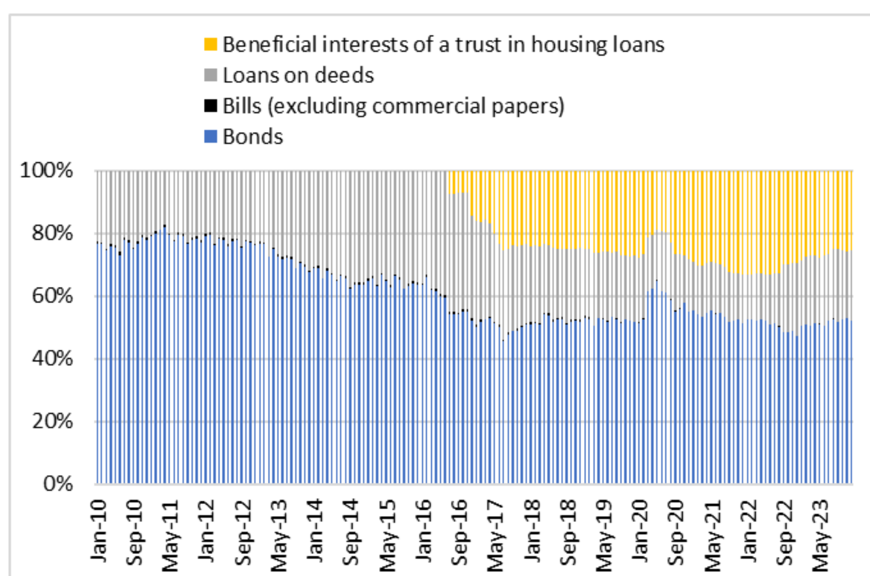
[53] Ideally the term of the executives (now two years) and the non-executive members (now one year) should be longer than the political cycle to reduce political dependencies. In the same vein, a Governor or Deputy Governor can be removed from office if the PM "finds that it is inappropriate for the officer to remain in office," which, because of its lack of specificity, could be used for arbitrary or politically motivated dismissals.

Annex I. BOJ Collateral Framework

1. As of December 2023, the total face value of collateral accepted by the BOJ amounted to JPY 158 trillion. The collateral consisted of bonds, including treasury discount bills (51.9 percent), loans on deeds (22.4 percent), beneficial interests of a trust in housing loans (25.7 percent), and others (0.03 percent).[1]

2. Until April 2016, more than 60 percent of collateral typically comprised bonds, while the rest was loans on deeds. However, financial institutions' holding of eligible collateral has decreased as JGB purchases by the BOJ have progressed under Quantitative and Qualitative Monetary Easing. In light of this situation, the BOJ started to accept beneficial interests of a trust in housing loans as eligible collateral. Since then, the share of government bonds started to gradually decline and there has been a significant increase in the use of trust in housing loans as collateral, which now constitute around 25 percent of the collateral (Figure 1).

Figure 1. Japan: Collateral Accepted by the BOJ by Category



Sources: IMF Staff; and BOJ.

3. The BOJ has three principles for treatment of the eligible collateral: i) maintaining the soundness of the BOJ's assets, ii) ensuring smooth business operations of the BOJ and efficient use of collateral, iii) utilizing market information to evaluate the creditworthiness of the assets accepted as collateral and to calculate its haircuts such as ratings by rating agencies and market prices. Regarding the eligibility standard in general, collateral should be denominated in the Japanese Yen and issued in Japan and governed by Japanese law.

[1] For more details within each category, see the BOJ Guidelines on Eligible Collateral.

4. However, in addition to the standard domestic collateral, the BOJ also publishes general guidelines prescribing the principles concerning foreign bonds denominated in foreign currencies that become eligible collateral when deemed necessary for ensuring stability in financial markets or for conducting appropriate money market operations in view of developments in domestic and overseas financial markets.[2] The pricing of eligible collateral, depending on its remaining maturity, is determined by applying margins to market prices, face values, or outstanding principal balances.

5. These margins, which shall be reviewed in principle, are derived as follows:

I. For collateral with an obtainable market price, margins are calculated considering the historical fluctuations in market price over the duration needed for the BOJ to enforce its rights, including the security interest.

II. For collateral without an available market price, margins are determined based on estimated price fluctuations over the time required for the BOJ to exercise its rights, including the security interest.

III. The margins calculated in I. and II. shall be adjusted when necessary to ensure consistency in the BOJ's margin table as a whole in light of the creditworthiness and marketability of the collateral.

[2]The guidelines for eligible foreign collateral can be assessed at https://www.boj.or.jp/en/mopo/measures/term_cond/yoryo46.htm