Revisit Japan’s Experiences on Bank Resolution

- Implications to EU’s Bail-in Approach -

Jutaro KANEKO
Chief Representative in Brussels
Japan Center for International Finance

Tel. +32-(0)2-646-10-50
kaneko@jcif.be

I. Revisiting Japan’s experiences

II. Relevant rules

III. Monte Paschi’s case

Ⅳ. How would Japan have dealt with Monte Paschi’s case?

I. Revisiting Japan's experiences

Chronology of events

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1995-96: Rescue of "Jusen"s (non-bank housing loan corporations) with public money of 685 bil. yen

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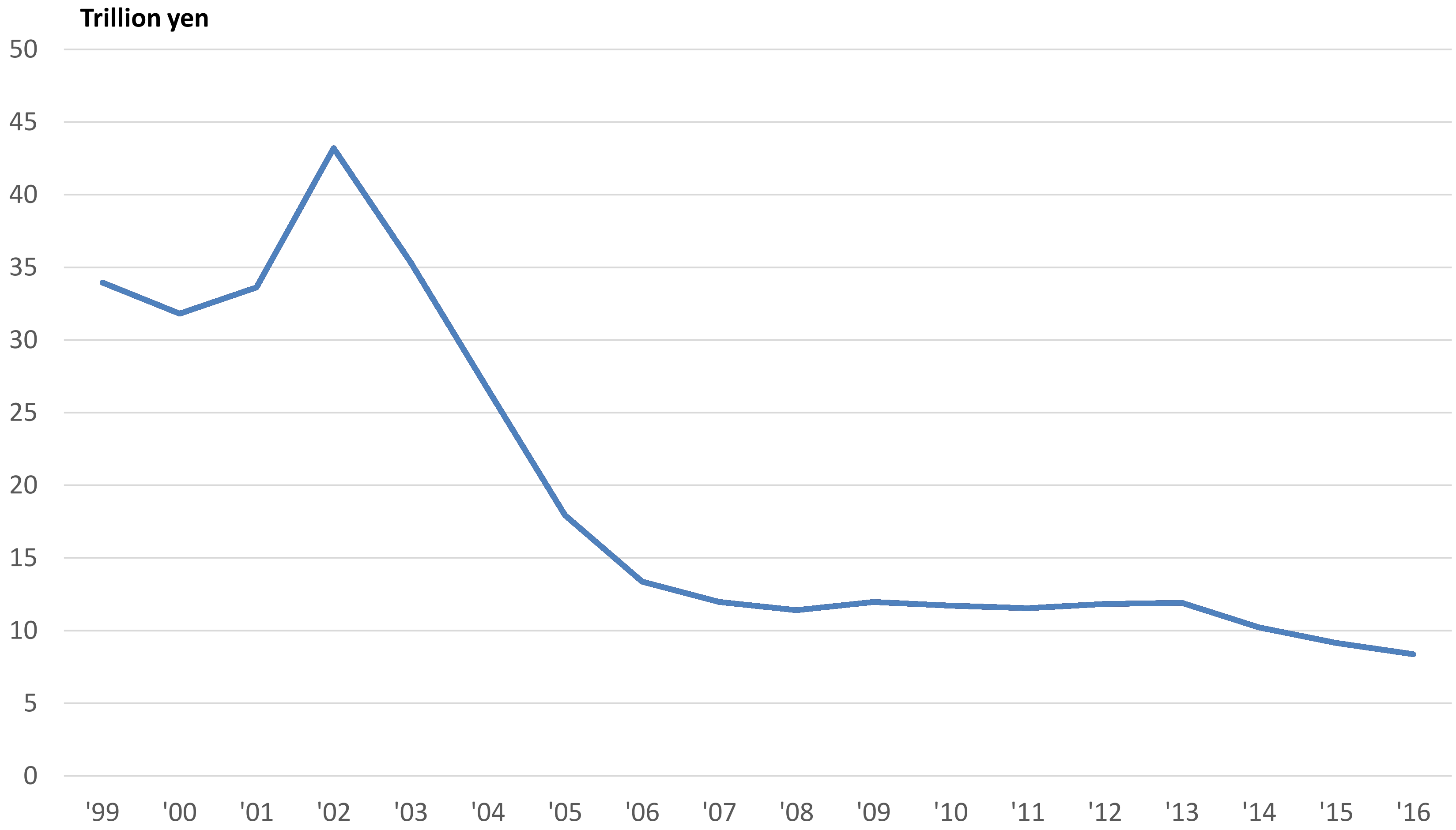
1997: Failure of Hokkaido Takushoku Bank, and surge of "Japan premium"

1998: Nationalization of Nippon Credit Bank and Long Term Credit Bank of Japan

1999: Capital injection into 15 major banks, and Placing 5 regional banks under management of Financial Reorganization Administrator

2003: Rescue of Resona bank, and failure of Ashikaga Bank

Transition of outstanding NPLs



Source: Financial Services Agency Japan

Results

- 20 banks became insolvent, due to total loss of around 100 trillion yen (equivalent to about 20 % of Japan's GDP) in the end
- Tax payers' money of 12.4 trillion yen (about 1 hundred billion EUR, equivalent to over 2 % of Japan's GDP) was spent temporarily for 34 banks in total
- Long-lasting credit crunch and slump in stock market had severe impacts on the real economy
- It took a decade to normalize banking sector (full repayment of public money by mega banks in 2006)

Causes

a) Banks kept rolling over non-performing loans/NPLs and hiding them, wishing for economic recovery

b) Political difficulty to save banks with public money (public resentment to Jusen rescue)

c) No effective scheme for orderly wind-down (safety net for financial stability) was in place at the beginning of the crisis

d) Lagged monetary easing by the central bank

e) Shortage of resources of the competent agency

Lessons learnt

- ✓ Exact amount of NPLs needs to be calculated in the first place
- ✓ When stability of financial system is at risk, NPLs should be written off to remove market uncertainty as soon as possible even with public money as necessary
- ✓ Responsible persons need to be punished to justify the public burden sharing (an analogy of “Bagehot Rule”)
- ✓ Appropriate legal framework and resolution authority with necessary powers are indispensable

II. Relevant rules

Overview

1. International standards

Financial Stability Board/FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions/Key Attributes

2. Local regulations which include

EU: Bank Recovery and Resolution Directive/BRRD (and State Aid Rule)

Japan: Amended Deposit Insurance Act

US: Dodd Frank Act and Federal Deposit Insurance Act

Switzerland: Banking Insolvency Ordinance

International standards

1. FSB's Key Attributes

- ✓ First published in 2011 in response to G20's commitment "Ending too big to fail" after the global financial crisis
- ✓ Aimed to be applied to all Systemically Important Financial Institutions/SIFIs
- ✓ Moral hazard (reliance on tax payers' money) vs systemic risk
- ✓ Resolution powers incl. bail-in (unsecured creditor claim's write-down or conversion into equity to implement capitalization or recapitalization), etc.

International standards (cont.)

2. FSB's future work

"The FSB identified the priorities for 2017 to help further advance progress which includes development of further guidance to support the resolution planning work of authorities and firms, including on the operational execution of bail-in" (excerpted from FSB's press release on 18 Aug. 2016).

National/Regional regulations (overview)

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- FSB member states are domestically implementing Key Attributes

- Compliance assessment on resolution powers

	EU	Japan	US	Switzerland
Availability of bail-in	✔	*	✔	✔
Replace management	✔	✔	✔	✔
Bridge bank	✔	✔	✔	✔

Source: FSB's second peer review report (March 2016)

* The FSB report explains it is not clear that Japan's resolution regime provides for powers to convert claims of creditors of the failed institution into equity of that institution or of any successor in resolution as required by Key Attributes.

Japan (amended Deposit Insurance Act)

- ✓ Deposit Insurance Act/DIA was amended in 2001 (also in 2013 for stabilization measures)

- ✓ Supervisors: Government's Financial Services Agency/FSA (and Bank of Japan)
  Resolution authorities: FSA and Deposit Insurance Corporation of Japan (DICJ)
  Trigger puller: Financial Crisis Response Council

- ✓ Para.1 of Article 102 of DIA stipulates "systemic risk exception" including public support and temporary nationalization even before the bank becomes likely to fail

- ✓ Bail-in based on contractual agreement

Crisis management (para1 of art. 102 of DIA)

Systemic risk determination: Possibility of significantly negative impacts on maintenance of the payment system in Japan or in a certain region where the financial institution is conducting business

Item 1: Thin capital (not failed or insolvent)

⇒ Capital injection by DICJ

Item 2: (Likely to be) failed or insolvent

⇒ Appointment of financial administrator; financial assistance exceeding pay-out cost; transferring operation to a sound financial institution

Item 3: Failed or insolvent

⇒ Transferring all existing shares of the bank to DICJ (temporary nationalization)

III. Monte Paschi’s case

Recent events

July 2016: Publication of EU stress test’s result and Monte Paschi/MPS’s recovery plan

Dec.2016: Moody's changed outlook on Italian banking sector from stable to negative due to increasing capital needs and weakening confidence

Dec.2016: Failure of MPS’s recovery plan to raise 5 bil. EUR in market (ECB rejected extension of the deadline)

Dec.2016: ECB’s calculated capital shortfall of 8.8 bil. EUR

Dec.2016: 8.8 bil. EUR state aid announcement based on exceptional clause of BRRD; i.e. Precautionary recapitalization

Present: State Aid Rule review by European Commission

Characteristics

- MPS is the third largest bank in Italy and is designated as an EU's Systemically Important Institutions/SIIs which ECB directly supervises
- Its subordinate debts are owned by retail investors (who might be misinformed of the risk)
- Italy has some troubled banks, and markets have little appetite and capacity for buying their assets/stocks
- Italian NPLs are legacy existing prior to BRRD
- Limited fiscal space for the government (Public debt exceeds 130% of nominal GDP) and lack of secondary market for NPLs
- Populism has risen also in Italy

Market data

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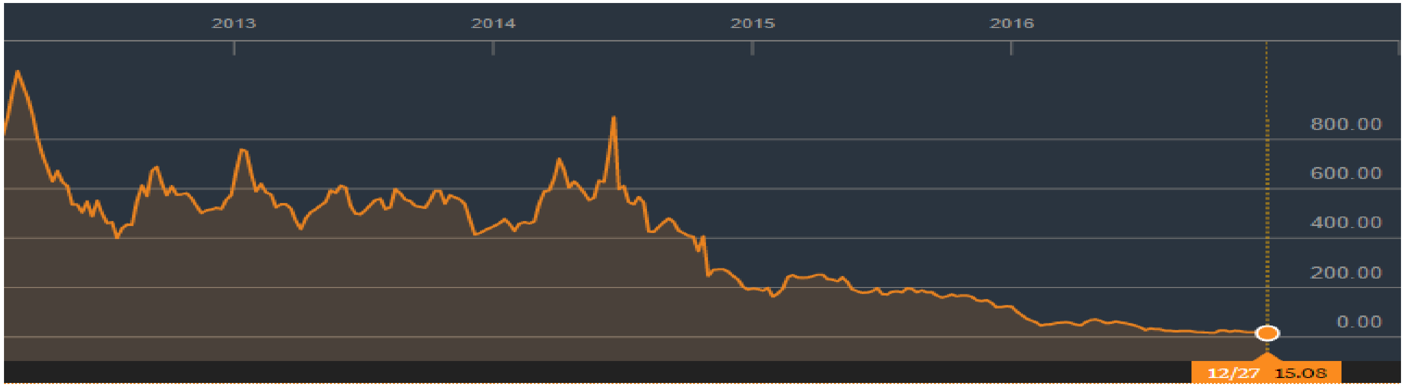
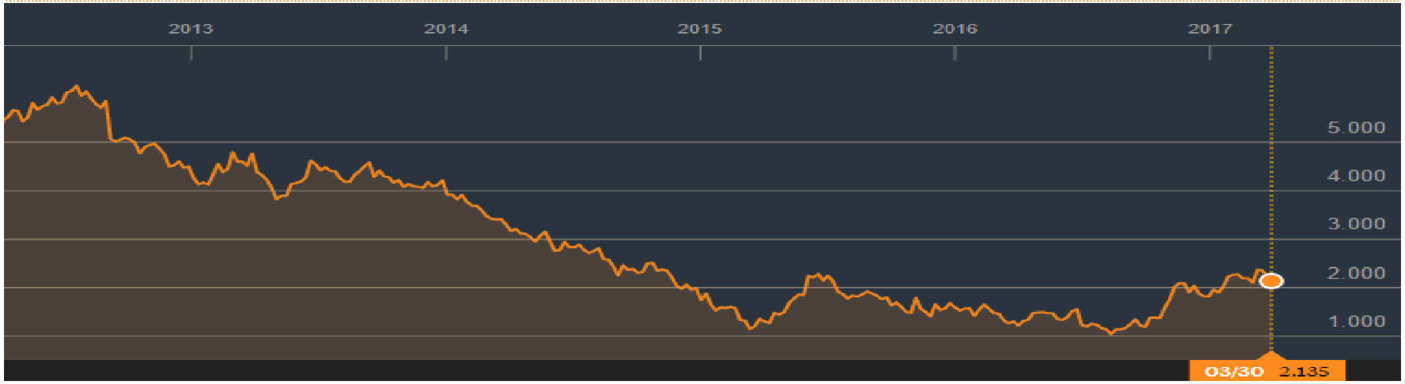
MPS stock price development (€)



Source: Bloomberg

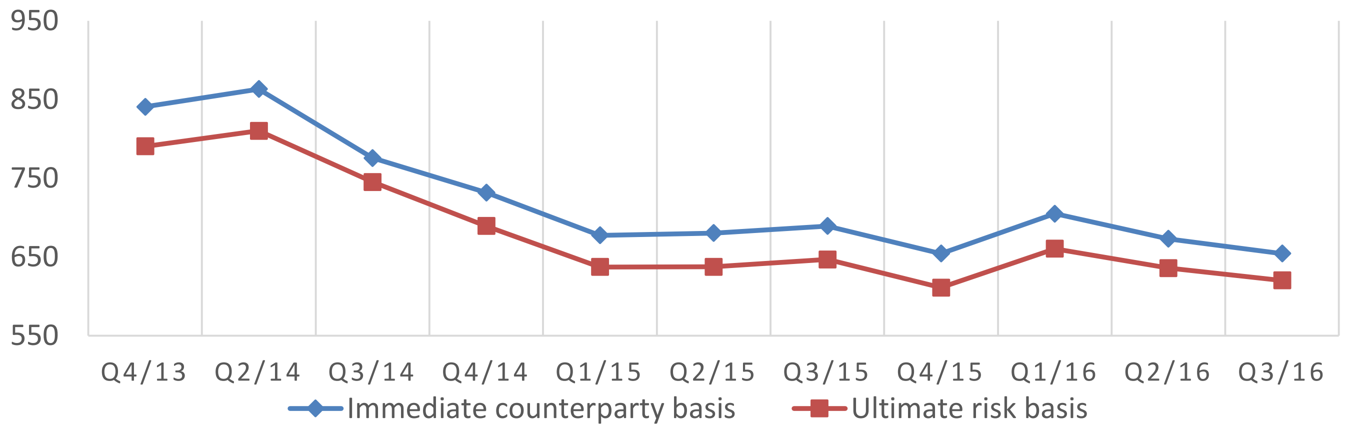
Italian 10 year sovereign bonds yield (%)



Source: Bloomberg

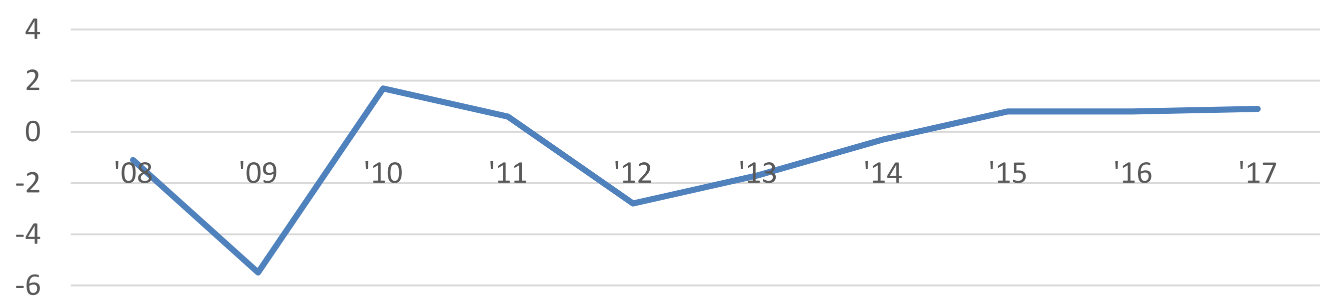
Economic & financial data

Foreign banks' consolidated positions in Italy (bil. UDS)



Source: BIS

Italian real GDP growth rate (%)



Note: Figures for '16 and '17 are based on projection Source: IMF

Ⅳ. How would Japan have dealt with Monte Paschi?

Lessons from MPS's case

1. ECB's dilemma (conflict of interests)
   - Executive Board vs member states
   - As supervisor vs as resolution trigger puller

2. Lagged and untransparent decision making
   - Aggravation of market sentiment and MPS's B/S, and spill-over effect on real economy (e.g. investment)
   - Restructuring cost could be reduced
   - Enhanced disclosure and communication is desired

3. Need of financial education for public, including retail investors

Implications for resolution policy?

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- Bail-in is an important part of an international agreement and should remain required as a backstop to prevent moral hazard (even after introduction of Minimum Requirement for Own Funds and Eligible Liabilities/MREL)

- However, it is a new concept and, in practice, the strict application might not be appropriate under the current situation in some member states

- Timely action by competent authorities is the key to reassure market participants and contain systemic risk

Considerations toward effective regime

- ✓ Intensified supervision as a baseline (but with risk of credit crunch)
- ✓ Closer collaboration between ECB and SRB
- ✓ Flexible use of public money under conditions such as :
  - clear plan for reimbursement
  - claw back/malus of remunerations paid
  - tighter supervision followed
- ✓ Strict corporate governance on banks
  - risk appetite framework
  - auditor’s control

Thank you for your attention!

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