(Provisional Translation)
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Financial Services Agency

The FSA's Approach to Introduce the TLAC Framework

Based on the experience of the recent global financial crisis, international efforts have been made to develop a framework for a prompt and orderly resolution of global systemically important financial institutions. The efforts are aimed at ending the so-called "too-big-to-fail" problem, which refers to the issue that national authorities not able to resolve globally active banks have no option but to rescue them by injecting public funds due to the concern that the unorderly failure of such financial institutions would have an extremely serious adverse effect on financial and economic systems in a number of countries.

It was with this in mind that the final agreement requiring global systemically important banks (G-SIBs) to have sufficient Total Loss-Absorbing Capacity (TLAC), submitted by the Financial Stability Board (FSB), was endorsed at the G20 Antalya Summit in November 2015.

The Financial Services Agency (FSA) already has in place the "Measures for Orderly Resolution of Assets and Liabilities of Financial Institutions, etc. for Ensuring Financial System Stability" through an amendment to the Deposit Insurance Act (promulgated in June 2013 and enforced in March 2014). Taking account of the progress in international discussions, particularly in response to the development of a new framework for the orderly resolution of G-SIBs, the FSA herein releases its approach to introduce the TLAC framework as hereto attached.

Based on the policy described in the attached document and further deliberations, the relevant regulations (including supervisory guidelines) will be revised.

<u>Please note that the policy described in the attached document is subject to change in line with ongoing international discussions or deliberations.</u>

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The FSA's Approach to Introduce the TLAC Framework

I. Total Loss-Absorbing Capacity (TLAC)

In November 2015, the Financial Stability Board (FSB) published the *"Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution / Total Loss-absorbing Capacity (TLAC) Term Sheet"* ("**TLAC Term Sheet**") which requires global systemically important banks (G-SIBs) to have sufficient Total Loss-Absorbing Capacity (TLAC). The purpose of the TLAC Term Sheet is to facilitate the orderly resolution of a G-SIB when it fails in a manner that minimises impacts on financial stability without exposing taxpayers to loss and ensures the continuity of its critical functions by imposing the losses on shareholders and creditors, in addition to meeting the recapitalisation needs of the G-SIB.

Under the TLAC Term Sheet, loss-absorbing and recapitalisation capacity will be required of G-SIBs alongside the regulatory capital adequacy requirement published by the Basel Committee on Banking Supervision, including *"Basel III: A global regulatory framework for more resilient banks and banking systems"* in December 2010 (revised in June 2011) and *"Final elements of the reforms to raise the quality of regulatory capital"* in January 2011 (collectively, the "**Basel Accords**").

II. Approach of the Financial Services Agency to TLAC

Considering that the TLAC Term Sheet is to incorporate the Basel Accords and that all of the Japanese financial institutions designated as G-SIBs by the FSB as of November 2015 are bank holding companies, the approach of the Financial Services Agency (FSA) to implement TLAC is mainly the amendment of the FSA Administrative Notice on Capital Adequacy Rules for bank holding companies pursuant to Article 52-25 of the Banking Act (Notice of FSA No.20 of 2006) ("**Pillar 1 Notice**"). The FSA will amend relevant regulations (including supervisory guidelines) in due course.

Since the framework for TLAC is closely linked to the strategy for an orderly resolution of G-SIBs, this paper will first outline the preferred strategy for an orderly resolution of Japanese G-SIBs (which means the banks designated as G-SIBs by the FSA in accordance with the designation by the FSB, including their respective group companies; the same shall apply hereinafter) which are bank holding companies, and then describe a funding structure to execute the preferred strategy and a model of resolution procedures under the TLAC framework.[1]

1. Preferred Strategy for Orderly Resolution: Single Point of Entry

The resolution strategies for systemically important financial institutions that are being developed internationally are broadly based on two stylised approaches: (i) SPE (Single Point of Entry) resolution, in which resolution powers are applied to the top of a group by a single national resolution authority, and (ii) MPE (Multiple Point of Entry) resolution, in which resolution tools are applied to different parts of the group by two or more resolution authorities acting in a coordinated way.

* FSB, *"Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies"*, July 2013

The FSA considers that the SPE resolution strategy is basically the preferred resolution strategy for Japanese G-SIBs taking account of resolvability based on their organisational structure as financial groups, including interconnectedness and interdependency within the groups. (NOTE)

Under an SPE resolution strategy, a possible model of Japanese G-SIBs' resolution will be as follows (details are described in 2.(2) below, and the Annex shows the schematic view of whole procedures):

(i) The bank holding company ("**BHC**") absorbs the losses incurred at a sub-group or a subsidiary that are designated separately as systemically important by the FSA ("**Material Sub-group**").

(ii) With respect to the BHC after absorbing the losses of the Material Sub-group, the Prime Minister confirms the necessity to take "Specified Measures Under Item (ii)" as set forth in Article 126-2, paragraph (1), item (ii) of the Deposit Insurance Act ("**DIA**"), and issues an Injunction Ordering Specified Management as set forth in Article 126-5 of the DIA (such BHC is referred to as the "**Non-viable BHC**" hereinafter).

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[1] Please note that this policy is not applicable to an orderly resolution of a foreign bank which is designated as a G-SIB by the FSB and its material sub-group which is incorporated in Japan.

(iii) The Non-viable BHC transfers its business relating to systemically important transactions (including shares of Material Sub-groups; the same shall apply hereinafter) to a Specified Bridge Financial Institution, etc., as set forth in Article 126-34, paragraph (3) of the DIA.

(iv) After transferring its business, the Non-viable BHC enters into court insolvency proceedings.

Note: The measures to be taken shall be determined by the relevant authorities on a case-by-case basis considering the actual condition of the G-SIB in its resolution phase. The FSA does not preclude the possibility of taking measures other than those stated above. Instead of applying the Specified Measures Under Item (ii) to the BHC under the SPE resolution strategy, for example, the Prime Minister may confirm the necessity to take "Specified Measures Under Item (i)" as set forth in Article 126-2, paragraph (1), item (i) of the DIA with respect to the BHC, or may confirm the necessity to take Specified Measures Under Item (i) or "Measures Under Item (i)" as set forth in Article 102, paragraph (1), item (i) of the DIA with respect to the Material Sub-group.

2. Funding Structure and a Model of Resolution Procedures to Meet TLAC Requirements under the SPE Strategy

(1) Funding Structure to Execute SPE Strategy

To execute the SPE strategy effectively in resolution, a BHC and its group companies shall restructure its flow of funding during business as usual for the purpose of ensuring the BHC's loss absorbing capacity and enable such losses ultimately to be absorbed by the BHC's shareholders and creditors. The following are the FSA's approach to (i) the issuance of External TLAC and (ii) the distribution of Internal TLAC to execute the SPE strategy with respect to Japanese G-SIBs.

(i) Issuance of External TLAC

The TLAC Term Sheet requires an entity to which resolution tools will be applied in accordance with the resolution strategy for the G-SIB ("**Resolution Entity**") to issue and maintain a certain volume of "TLAC-eligible instruments" that have loss-absorbing / recapitalisation capacity.

As the Resolution Entity of Japanese G-SIBs shall be the top-tier BHCs, the FSA will require them to meet a minimum requirement (NOTE) for instruments (including capital instrument, debt instrument, liability or other item) which are recognised to have loss-absorbing / recapitalisation capacity (such instruments are referred to as "**External TLAC**" hereinafter).

The TLAC Term Sheet stipulates that "Eligible external TLAC should contain a contractual trigger or be subject to a statutory mechanism which permits the relevant resolution authority to effectively write it down or convert it to equity in resolution." There is such a statutory mechanism in Japan; therefore, the FSA regards that debt instruments issued by the BHC shall not be required to contain a contractual trigger for loss absorption to be qualified as External TLAC.

Note: Based on the TLAC Term Sheet, the FSA will set the requirement for minimum External TLAC as follows:

	BHC's consolidated RWAs[2]	BHC's Basel III leverage ratio denominator[3]
From March 31,[4] 2019	16%	6%
From March 31, 2022	18%	6.75%

Under the TLAC Term Sheet, certain credible ex-ante commitments to recapitalise a G-SIB in resolution as necessary to facilitate an orderly resolution may count toward a firm's minimum External TLAC.[5] As the Japanese Deposit Insurance Fund Reserves fulfil the requirements for such a commitment, the FSA will allow Japanese G-SIBs to count the amount equivalent to 2.5% of the BHC's consolidated RWAs as from March 31, 2019 and 3.5% as from March 31, 2022 as their External TLAC in accordance with the TLAC Term Sheet.

[2] The amount equivalent to the denominator of the formula stipulated in each item of Article 2 of the Pillar 1 Notice (the same shall apply hereinafter)

[3] The amount equivalent to the denominator of the formula stipulated in Article 2 of the Consolidated Leverage Ratio separately designated by the Commissioner of the Financial Services Agency pursuant to Article 1, paragraph (1), item (vii) of the matters separately designated by the Commissioner of the Financial Services Agency regarding the adequacy of equity capital, etc. pursuant to Article 19-2, paragraph (1), item (v) (d) of the Ordinance for Enforcement of the Banking Act (Notice of FSA No.13 of 2015) (the same shall apply hereinafter)

[4] Though the TLAC Term Sheet requires that G-SIBs meet the requirements as from January 1, the FSA will implement the TLAC requirement for Japanese G-SIBs in line with the Japanese financial year, which runs from April 1 to March 31, in the same manner as the implementation of the Basel Accords in Japan. (the same shall apply hereinafter)

[5] Section 7 of the TLAC Term Sheet

(ii) Distribution of Internal TLAC

According to the TLAC Term Sheet, TLAC generally should be distributed as necessary within resolution groups in proportion to the size and risk of exposures of its material sub-groups which meet certain requirements.[6]

In line with the TLAC Term Sheet, the FSA will require the top-tier BHCs of Japanese G-SIBs to have their Material Sub-groups maintain a minimum requirement for loss-absorbing and recapitalisation capacity, by accepting eligible instruments (including capital instrument, debt instrument, liability or other item) issued by those subsidiaries forming the Material Sub-groups (such instruments are referred to as "**Internal TLAC**" hereinafter).

According to the TLAC Term Sheet, while Material Sub-groups shall consist of subsidiaries incorporated in the jurisdictions outside of their Resolution Entity's home jurisdiction in principle, authorities in the Resolution Entity's jurisdiction may decide to apply internal TLAC requirements (or similar requirements) to subsidiaries or sub-groups within their jurisdictions. Therefore, the FSA will designate Japanese G-SIBs' domestic subsidiaries or sub-groups, in addition to overseas subsidiaries or sub-groups, as Material Sub-groups based on certain conditions, considering the criterion for Material Sub-groups stipulated in the TLAC Term Sheet.

(2) A Model of Procedures of Orderly Resolution under the SPE Strategy

Along with the model described in the above 1.(i) through (iv), the details of the intended procedures of Japanese G-SIBs' orderly resolution will be as follows:

(i) Absorption of the Losses of the Material Sub-group by the BHC

To implement the orderly resolution of a Japanese G-SIB, losses incurred at its Material Sub-group will be absorbed by the BHC through internal TLAC that would have been distributed, with certain involvement of the authority.

[6] Such requirements for material sub-groups are stipulated in Section 17 of the TLAC Term Sheet

(ii) Specified Confirmation by the Prime Minister[7]

When the BHC which absorbed the losses from the Material Sub-group fulfils the requirements for the application of Specified Measures Under Item (ii) as set forth in the DIA, the Prime Minister shall confirm the necessity to take Specified Measures Under Item (ii) and issue an Injunction Ordering Specified Management following deliberation by the Financial Crisis Response Council with regard to the BHC (i.e. the Non-viable BHC).

At this point, Basel III-eligible Additional Tier 1 instruments[8] and Tier 2 instruments issued by the Non-viable BHC will be written off or converted into equity under the terms and conditions of such instruments[9] prior to other liabilities including the External TLAC eligible debt liabilities.

In addition, a movable or claim pertaining to the business of the Non-viable BHC that shall be succeeded to the Specified Bridge Financial Institution, etc. under (iii) below (limited to those designated by the Prime Minister) may not be seized pursuant to Article 126-16 of the DIA.

(iii) Transference of Business

The Non-viable BHC transfers its business to the Specified Bridge Financial Institution, etc. incorporated by the Deposit Insurance Corporation of Japan ("**DICJ**") with the permission of the court in lieu of the extraordinary resolution of the shareholders' meeting pursuant to Article 126-13, paragraph (1), item (iii) of the DIA, under a decision by the Prime Minister that the Specified Bridge Financial Institution, etc. should carry out the Specified

[7] To avoid market turmoil, such process will be promptly implemented within a weekend.

[8] With regard to Japanese G-SIBs, Additional Tier 1 instruments in the form of debt liabilities issued by BHC on and after March 31, 2013 will also be fully or partially written down or converted into equity when the consolidated Common Equity Tier 1 ratio that is calculated under the Pillar 1 Notice falls below 5.125%.

[9] The Basel Accords require that such write-off or conversion shall be triggered at the point of non-viability (PONV), that is, at the point of (1) a decision that a write-off, without which the issuer would become non-viable, is necessary, as determined by the relevant authority, or (2) the decision to make a public sector injection of capital, or equivalent support, without which the issuer would have become non-viable, as determined by the relevant authority. Under the Pillar 1 Notice, the point of non-viability with respect to BHC means the point when the Prime Minister confirms the necessity to take Specified Measures Under Item (ii) to the BHC.

Assumption of Business, etc. in order to succeed to the business of the Non-viable BHC pursuant to Article 126-34, paragraph (1), item (ii) of the DIA.[10][11]

At this point, it is expected that the obligation of the External TLAC eligible debt liabilities will not be transferred to the Specified Bridge Financial Institution, etc., and the Non-viable BHC continues to be the obligor of such liabilities.

(iv) Court Insolvency Proceedings of the Non-viable BHC

After transferring its business under (iii) above, the DICJ files a petition for the commencement of bankruptcy proceedings against the Non-viable BHC. It is expected that the Non-viable BHC will enter into "liquidation proceedings" (in particular, bankruptcy proceedings) through which the company will be dissolved, not into "reconstruction procedures" through which business continuity will be attempted.

In this case, creditors of the Non-viable BHC, including the holders of the External TLAC eligible debt liabilities, will receive liquidating distributions within the scope of the Bankruptcy Estate under the Bankruptcy Act or relevant laws, and thus will absorb the losses in the bankruptcy proceedings.

[10] Material Sub-groups are assumed to continue their business as usual.

[11] The Specified Bridge Financial Institution, etc. will transfer its business to financial institution(s) within two years in principle after the Specified Confirmation with regard to the BHC by the Prime Minister. (Article 126-37,Article 96, paragraph (1) and Article 126-3 of the DIA)