March 3, 2011

Comments on the European Committee's Consultative Document,
Technical Details of a Possible EU Framework for Bank Recovery and Resolution

Japanese Bankers Association

The Japanese Bankers Association (JBA) is an industry association of 139 Japanese banks and 46 non-Japanese banks with operations in Japan.

The Japanese Bankers Association appreciates this opportunity to comment on the Consultative Document, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution*, released January 6, 2011, by the European Commission.

We hope that our comments below will assist in finalizing rules in the EU going forward.

【General Points】

We understand that this proposal applies to the EU and is based on the experiences of the recent financial crisis. Further, an internationally-coordinated approach is needed in achieving the proposed rules and framework for recovery and resolution planning. Also, the European Commission should be receptive to reviewing the proposed framework before implementation, should it become evident that achieving international coordination is difficult.

We hope that the following points will be considered by the European Commission as it ensures stability in the financial system and completes an effective recovery and resolution framework, both within and outside the EU.

【Specific Points】

1. *Proportionality (page 37) (Preliminary preventive powers (D5))*

Proportionality is suggested as a condition of implementing recovery and resolution plans. However, we seek further clarity, as the factors in determining the degree of proportionality are unclear. For example, we encourage consideration of a

definition based on liability size or whether financial institutions are systemically important, which is currently being considered by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (the Basel Committee).

2. *Conditions for resolution (F1) (page 46) (Part 4: RESOLUTION TOOLS AND POWERS, F- Resolution: conditions, objectives and general principles)*

（1）Reconsideration of Option 3

Three options are proposed regarding resolution procedures when a bank is failing or likely to fail: 1）Option 1 (ordinary liquidation), which depends on financial conditions; 2) Option 2 (orderly wind down with a bridge bank and/or sale of businesses); or 3) Option 3 (restructuring as a going concern). Basically, responding with Option 1 is the standard in a crisis management process as there is a framework that grants powers of early intervention to the supervisors (Part 4 describes measures based on early intervention).

Option 2 suggests a condition based on supervisory assessment of continued compliance with the conditions for authorization—in other words, meeting conditions of banking license. This option does not clearly show early intervention measures, and is understood to serve as an ordinary wind down while meeting the condition of banking licenses. Option 3 sets capital triggers using minimum capital requirements and requires banks' debt to be written down when banks fail to meet the minimum levels. Furthermore, under Option 3 when certain trigger conditions are met, resolution tools may be used as additional measures (meaning using Option 1). However, the measures described in Option 3 are considered to be a tentative or temporary response until financial conditions recover and orderly liquidation (Option 1) is possible. Therefore, this should first be explained clearly.

In past financial crises, when problems arose, it became clear that procrastination in resolving those issues resulted in enormous costs. In the crisis management process, authorities, who normally are in a better position than creditors to assess the financial conditions of individual banks and the financial system as a whole, can implement early intervention actions, and, furthermore, executing the resolution tools–(a) sale of business, (b) bridge bank, and (c) asset separation (page 51)–is considered a reasonable expansion of Option 1. In Option 3, determining whether orderly resolution is possible

or not depends on the judgment of authorities, and there are concerns that a new Too-Big-to-Fail problem could occur. Therefore, given these conditions, Option 3 should be redesigned more carefully as a resolution measure.

（2） *Addressing liquidity problems*

Furthermore, we note that this proposal does not address liquidity problems, an important issue in the resolution process. For example, as the failure of Northern Rock Bank in the UK showed, a response was necessary within a time frame different from a time frame under normal conditions. We propose establishing a framework that would address such issues.

3. *Debt conversion tool (page 51) (Resolution tools: General) (G1)*

(Relationship with general principles)

There are four general resolution tools: (a) the sale of business tool; (b) the bridge bank tool; (c) the asset separation tool; and (d) the debt conversion tool.

Concerning (d) the debt conversion tool, when the writing off mechanism is used and there is no possibility of writing up, the tool does not satisfy the three of five general principles governing resolution (F4) (page 49): *(a) shareholders first bear the losses of the credit institution; (b) unsecured creditors bear the residual losses; and (d) creditors of the same class are treated in fair and equitable manner, and no creditor incurs greater losses that would be incurred under liquidation.* We think that the relationship between (d) the debt conversion tool and the general principles governing resolution should be shown clearly.

(Responsibility of supervisors)

The debt conversion tool is a tool that is triggered based on the determination of supervisors and raises the responsibility of supervisors. We would like greater effort in increasing the effectiveness of early intervention, for example by enforcing supervision, because the reputation of the supervisors could be damaged when the intended result is not attained.

The debt conversion tool in financial institutions' crisis management processes is used after a problem occurs and the institution's own efforts are found to be inadequate

and improvement does not appear likely even after the early intervention of authorities and the institution is failing or likely to fail. Triggering such a tool can be considered tantamount to authorities guaranteeing that the financial institution can recover. If, as a result of the trigger, the intended result is not achieved, the authorities have a considerable responsibility vis-à-vis the creditors in taking measures that depart from the general principles. Thus, authorities must make every effort to ensure effective supervision.

4. Ensuring international consistency of the debt write down tool (page 55)

The Basel Committee on January 13, 2011 reached an agreement on the minimum requirements to ensure loss absorbency at the point of non-viability of non-common Tier 1 and Tier 2 instruments. There should be adequate international collaboration so that inconsistency does not arise between EU regulations and international requirements of the Basel Committee regarding terms and conditions and authorities' discretion related to loss absorbability of senior debt. Harmonization of regulatory frameworks should be ensured.

With regard to the debt write down tool, as the European Commission has pointed out, it is important that EU policy should take proper account of the outcome of the Basel Committee and the FSB work stream in the context of improving the resolvability of systemically important financial institutions (SIFIs) and aim for international consistency as much as possible.

The Basel Committee's January 13 release of a final version of *Minimum requirements to ensure loss absorbency at the point of non-viability* for non-common Tier 1 and Tier 2 instruments stipulates that any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock. However, as the Basel Committee still does not have a clear response for the write down mechanism of senior debt, we note our concern that confusion and/or inconsistencies could arise in the financial market regarding investors' valuation of bank-issued corporate bonds when EU responses are inconsistent with internationally agreed-upon measures.

5． *ANNEX: Debt write down as an additional resolution tool*

（1） *Q62a : What classes of debt (if any) may need to be excluded from a statutory power to write down senior debt? (page 88)*

The write down mechanism should not apply to loans but only to senior bonds after subordinate debt is written down.

This is because debt in the form of loans is often difficult to transfer, and pricing is also unclear. But bond pricing is relatively transparent, and bondholders can sell their holdings by assessing price vis-à-vis risk. Bonds are therefore acceptable for the write down mechanism. Furthermore, in terms of spread level, because bond yields are generally higher than loan yields, bond investors are more willing to consider write-downs.

（2） *Q62b: Is it desirable to undermine the principle that creditors of the same ranking should be treated similarly? Should a discretionary power allow authorities to discriminate within classes of debt? (page 88)*

We believe that treatments should differ based on the debt holder's tax home and currency of the debt.

First, we do not think it is appropriate to protect EU taxpayers by writing down senior debt held by non-EU creditors (eg., Japanese financial institutions) if write downs of senior debt are intended to protect European taxpayers. Therefore, senior debt held by creditors who do not hold EU permanent establishment (PE) nor pay corporate taxes should be exempted.

Further, regarding debt currency, senior debt issued and/or traded in a currency other than Euro should be exempted.

The bulk of such debt denominated in a currency other than Euro is believed to be held by investors in the currency of their own country (eg., JPY-denominated debt by Japanese investors, USD-denominated debt by US investors). We do not think it is appropriate that non-European investors should bear a burden if write down measures for senior debt are intended to protect European taxpayers. Specifically, any JPY- or USD-denominated loans to or bonds of European financial institutions that may fail should be exempted.

（3） Q65: Compensating mechanisms (page 90 and 91)

Conversion to equity as the compensating mechanism is limited in terms of increasing incentives for a wide range of investors to purchase debt. If senior debt only has common share conversion provisions as a compensating mechanism, investors willing to purchase bank corporate bonds would inevitably be limited.

Therefore, in order to capture demand for bank corporate bonds from the market, further measures would be necessary, such as schemes that function as purchasers of converted shares. From the viewpoint of financial institutions issuing corporate bonds, a framework for such measures should be carefully introduced after adequate market analysis.

6. *Other issues*

（1） Treatment of foreign banks not headquartered in the EU

This proposal does not clearly address the scope of application for recovery and/or resolution plans for non-EU banks' subsidiaries and branches located in the EU. For example, it is unclear whether recovery plans are sought on a group basis for Japanese banks or if separate recovery plans are sought for Japanese banks' overseas subsidiaries located in the EU. We seek further clarification on this matter.

（2） Assessment of fair value

The proposal addresses regulations to be followed by authorities in applying resolution tools in case of resolution proceedings. For example, we seek clarification on how authorities assess fair value of financial institutions, including a list of factors to be considered.