

Keynote Speech by Masamichi Kono
at the 9th DICJ Roundtable
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It is my great honor and pleasure to be with you this morning on the occasion of the 9th DICJ Round Table, hosted by the Deposit Insurance Corporation of Japan.

Today, I would like to introduce to you an important piece of work undertaken in the context of international regulatory reform in the wake of the global financial crisis after the failure of Lehman Brothers in September 2008. My speech today will focus on the three points listed in Slide 1.

1. Overview of FSB work on resolution

The issue of how to make for an orderly resolution for systemically important financial institutions (SIFIs) is sometimes depicted as the issue of “resolving the ‘too-big-to-fail (TBTf)’ issue.” Essentially, it has been an effort to enable and ensure an orderly resolution of systemically important financial institutions (SIFIs) without taxpayers bearing losses.

Under the leadership of the G20 Leaders, this work was made one of the main pillars of the international financial regulatory reform work at the Financial Stability Board (FSB).

Slide 3 shows the three main strands of work to accomplish this, as agreed by the G20 Leaders in November 2011. Those are, namely: i) putting in place a regulatory framework for preventing failure of financial institutions by requiring additional loss absorbency for those institutions designated as global systemically important financial institutions (G-SIFIs), ii) agreeing on a new international standard for resolution regimes, and iii) strengthening supervision of SIFIs to make it more intensive and effective.

As regards item i), in the case of banks, some 30 global systemically important banks (G-SIBs) were designated by the FSB based on an agreed assessment methodology, and they were applied a surcharge of CET1 capital scaled in accordance with their relative riskiness. (See Slides 4-6) Regarding item ii), the new international standard for resolution schemes was named the “Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes)”, which was adopted by the FSB and endorsed by the G20 Cannes Summit in November 2011. (Slide 7)

Slides 7 and 8 very briefly describe the objective and the content of the Key Attributes. FSB members committed themselves to implementing the Key Attributes in their jurisdictions, with periodic peer reviews to make sure that this commitment is honored by all FSB members. In the case of Japan, the Deposit Insurance Act was revised in June 2013 to implement the Key Attributes, as shown in Slides 9-13. The FSB has been pressing forward with setting out a number of guidance papers and principles, and each jurisdiction has introduced, or is now introducing, a framework that should match the standards set out in the Key Attributes.

2. Recent progress in removing obstacles to resolvability

In the G20 Leaders’ Declaration at the St. Petersburg Summit held in September 2013, the Leaders renewed their commitment “to make any necessary reforms to implement fully the FSB’s Key Attributes for all parts of the financial sector that could cause systemic problems” and committed to “undertake the necessary actions to remove obstacles to cross-border resolution.” (Slide 15)

Slide 16 is a list of issues that the FSB identified in removing the said obstacles. One of the most important subjects in this context was how to ensure additional loss absorbing capacity in resolution,

and how to recapitalize the entity succeeding the critical activities of the resolved entity in the resolution process. After extensive discussions involving a quantitative impact study, market survey and macro-economic impact study, FSB members agreed to a requirement of total loss absorbing capacity (TLAC) in November 2015. TLAC consists of Basel III regulatory capital and long-term bail-inable debt.

The TLAC requirement is designed to strengthen the credibility of authorities' commitments to resolve failing G-SIBs without resorting to taxpayers' money, thereby helping remove the "implicit public subsidy" from which G-SIBs may benefit based on the market's expectation that authorities would not be able to place them in the process of resolution. At the same time, the requirement is aimed to incentivize TLAC holders to better monitor a G-SIB's risk-taking activities. The new standard, by enabling an orderly resolution of a G-SIB through bail-in of eligible debt, is designed to help end the TBTF problem.

Slide 17 describes what TLAC is, and the process for developing the TLAC standard at the FSB, and Slides 18-20 explains the main requirements.

Slides 21 and 22 explain another important element of a framework for effective resolution of G-SIBs, which is a stay on early termination rights for derivative and other market transactions. A temporary stay of this kind is critical if a default event in one jurisdiction should not trigger a disorderly resolution of the entire cross-border banking group.

However, the development of a workable resolution framework backed by cross-border arrangements, while already a major challenge, is not sufficient to ensure resolvability of the G-SIB. Issues around: i) satisfying the funding and liquidity needs of banks' critical functions, ii) ensuring operational continuity of those critical functions, and iii) effective coordination and

cooperation mechanisms between regulatory, supervisory, and resolution authorities of multiple jurisdictions would be required to ensure true “resolvability”. Slide 23 describes an FSB process to assess the resolvability of each of the G-SIBs, through a Resolvability Assessment Process (RAP), to identify impediments to an orderly resolution. Slide 24 introduces FSB work related to securing funding in resolution and ensuring operational continuity of the critical services of a G-SIB.

In addition, to prevent future financial crises, it is also important to look at systemically important financial institutions other than banks, as various types of non-bank financial institutions are interconnected with G-SIBs and between themselves. Global insurers and systemically important financial infrastructures such as CCPs would also need to be placed under orderly resolution regimes. Therefore, the FSB is stepping up its efforts to develop and implement resolution regimes for non-bank entities such as global systemically important insurers (G-SIIs) and financial market infrastructures (FMIs). Slides 25 and 26 describe the core elements of this work at the FSB. At the moment, the identification by the FSB of systemically important non-bank entities other than insurers and FMIs is suspended, due to priority given to identifying and properly managing the risks of the activities of such non-banks (taking a so-called activities-based approach).

Slides 27 and 28 show the remaining challenges and on-going work to ending TBTF. It should be noted that when dealing with the issue of stay on early termination rights, ISDA (International Swaps and Derivatives Association) has been playing a critical role in developing the ISDA Protocol, and playing a coordinating role between the individual market participants and the regulators and supervisors concerned.

3. The critical role of deposit insurance

Finally, I would like to emphasize the importance of deposit insurance regimes in jurisdictions in the work to end TBTF, and also the critical role deposit insurers play in the resolution process. Slides 30 is about the key role that deposit insurance schemes play in jurisdictions. The protection of retail deposits, which is the core function of a deposit guarantee fund, would play an important role in enabling an orderly resolution by maintaining confidence among retail depositors and preventing bank runs.

Slide 31 describes the role of deposit insurers in resolution, and its potential to mutualize the costs of a bank failure. There may be some differences of views around the exact role deposit insurance schemes should be playing in the resolution process of G-SIBs. But I should refer you to the fact that, in many jurisdictions, deposit insurers play important roles in resolution, including as receivers and as resolution authorities as well as providers of liquidity in resolution.

In addition, to the extent that such funds could be bailed-in in the resolution process to absorb losses and recapitalize the critical functions of the bank, they can be an effective mechanism for avoiding taxpayers bear losses. Here, I may refer to the FSB's TLAC agreement which provides for a role of *credible ex ante commitments* made by deposit guarantee funds to bear losses and recapitalize G-SIBs in resolution.

Slide 32 emphasizes the importance of cross-border cooperation between deposit insurers in operationalizing an orderly resolution and IADI's role in promoting cross-border cooperation. In this vein, I would like to encourage the IADI to actively participate in the FSB work and to support national deposit insurers understand and take necessary steps to contribute to building an orderly resolution process in each jurisdiction.

I understand IADI's role to have been focused mainly on standard-setting for deposit insurance schemes, but it could also play a useful role in promoting international cooperation among resolution authorities in the context of ending TBTF.

In this context, I have always mentioned that having the right framework is only a first step, and making all this operational would be critical. Above all, restoring confidence in the integrity and stability of the financial system is the only way to end a financial crisis. If the public is not confident that the resolution regime in place is resilient and robust enough to be able to ensure the continuity of the critical functions of a bank, and the relevant authorities capable of managing the situation without major disruptions, the framework will not achieve its objective.

The FSB has agreed on TLAC, but some effort is needed to gain confidence in the effectiveness and robustness of such a measure. Confidence in each jurisdiction's deposit insurance system is also a key component of confidence in the financial system.

By now, we have gone through a sufficient number of worse-enough financial crises in our lifetime to be able to learn from our experiences, particularly from our mistakes in the past, and build such "resolution infrastructures", combined with the necessary "software" and "operational guides" to make the system work when there is a need. Japan, with its rich experience of having gone through so many bank failures in the last 25 years would certainly have something to contribute to the global endeavor.

Thank you very much for your kind attention. I look forward to the discussions today, and wish you all a truly fruitful roundtable meeting.