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Amendments to the Banking Act of Japan

In accordance with the final report titled "Method of Regulations on Banks which Contribute to the Stability of the Financial System, etc." of the Financial System Council[1], the Banking Act (Act No. 21 of 1947, as amended, the "**BA**") and the subordinate regulations[2] have been amended and the main part of the amendments ("**Amendments**") became effective from April 1, 2014.

This newsletter provides an overview of the Amendments, which mainly consists of:

(i) the relaxation of limitations on domestic banks in respect of holding the voting rights of other companies;
(ii) the relaxation of regulations on the scope of permitted business for domestic banks' subsidiaries in respect of outbound M&A transactions;
(iii) the relaxation of requirements in respect of agency and intermediary services for foreign banks;
(iv) the tightening of regulations on foreign bank branches; and
(v) the tightening of large exposure limits (the revision effecting this item will take place within one and a half years from June 19, 2013).

1. Relaxation of Limitations on Domestic Banks in respect of Holding the Voting Rights of Other Companies – the So-Called "5 Percent Rule"

Under the BA, in principle, domestic banks' groups are prohibited from holding more than 5 per cent of the voting rights of companies in Japan which do not fall under permitted exceptions. The Amendments has relaxed this prescription, with the aim of encouraging banks to provide capital funds through widening the category of exceptions under the BA.

(1) Relaxing requirements for holding specified voting rights

The time limits and the holding ratio limits in respect of the acquisition or holding of voting rights by a bank's group have been amended in the following ways:

- ✓ for voting rights held by a bank as a limited partner under the Limited Partnership Act for Investment, the 10 years limit has been abolished;
- ✓ for voting rights of a company which falls under one of the categories to conduct venture businesses under the BA held through the bank's group's investment -specialized subsidiary, the limit has been extended to 15 years from 10 years;
- ✓ for voting rights acquired through the conduct of a debt equity swap transaction, the time limit has been extended to 10 years from 1 year and the 50 per cent holding

[1] The Financial System Council is a consultative body of the Japanese Prime Minister, the Commissioner of the Financial Services Agency and the Minister of Finance.
[2] The Order for the Enforcement of the BA and the Cabinet Office Ordinance of the BA

ratio limit has been abolished; and

- ✓ for voting rights held in the account of a trust bank as trust property where such trust bank has the authority to execute the voting rights as a trustee (subject to certain exceptions), the 1 year time limit and the 50 per cent holding ratio limit have been abolished.

(2) Voting rights of companies undergoing the business revitalization procedure

Following the Amendments, a bank may directly acquire or hold the voting rights of a company which falls under the category of companies that is undergoing a business revitalization procedure as prescribed in the BA. Before the Amendments, a bank's group could acquire or hold such voting rights only through the bank's group's investment -specialized subsidiary.

Following the Amendments, the time limit for a bank directly holding the voting rights of such a company undergoing business revitalization is basically 3 years, and up to 5 years are permitted where the target company is a small and/or medium-sized enterprise. If a bank's group holds this type of voting rights through the bank's group's investment -specialized subsidiary, the time limit is 10 years, the same as before the Amendments.

(3) New exception

A new exception, a "special exception company", has also been established pursuant to the Amendments. This type of company is defined as a company which conducts business and activities that contribute to the development of local and rural areas, and as a prerequisite to qualifying as such special exception company, the involvement of the Regional Economy Vitalization Corporation of Japan (REVIC) in certain ways prescribed by law vis-à-vis the company in question is required.

Voting rights under the special exception company may be held through a bank subsidiary specialized in investment for up to 10 years, as long as the company does not fall under the definition of "subsidiary corporations etc. (*ko-houjin tou*)" of the bank as defined under the BA[3]. Accordingly, in general, a bank subsidiary specialized in investment holding less than 40 per cent of the voting rights of the special exception company will be permissible.

2. Relaxation of Regulations on the Scope of Permitted Business for Domestic Banks' Subsidiaries in respect of Outbound M&A Transactions

The scope of permitted business for banks' subsidiaries is limited to that as prescribed in the BA. This regulation affected Japanese banks' merger and acquisition transactions in respect of overseas financial entities, because subsidiaries acquired or held as a result of such transactions would also be subject to this business scope limitation. Accordingly,

[3] In principle, a company that has more than 50 per cent of its voting rights held by a bank and/or the bank's subsidiaries falls one of the "subsidiary corporations etc." of the bank. In addition, even where a bank does not hold more than 50 per cent of the voting rights, a company may fall under the "subsidiary corporations etc." category if (i) a bank holds 40 per cent or more of the voting rights of a company and has effective control over such company, or (ii) a bank is deemed to hold more than 50 per cent of the voting rights of a company together with the bank's closely related parties.

Japanese banks were required to refrain from transactions with financial companies or financial holding companies that had subsidiaries outside of this stipulated scope.

Following the Amendments, Japanese banks may now hold foreign subsidiaries which conduct non-permitted business under the BA for 5 years so long as these subsidiaries are held as a result of a merger and acquisition transaction.

3. Relaxation of Requirements in respect of Agency and Intermediary Services for Foreign Banks

In principle, the BA requires a foreign bank to be licensed when it solicits banking transactions in Japan, including deposits, loans and fund remittances. The framework of agency or intermediary services for foreign banks, which is subject to permission from the Commissioner of the Financial Services Agency (the "**FSA**"), is designed to provide an exception to this principle by permitting a foreign bank to make a Japanese entity, which possesses a Japanese banking license, to function as an agent or intermediary of a foreign bank. Under this framework, certain capital ties were required between the agent or intermediary bank in Japan and the foreign bank. However, following the Amendments, when a domestic bank conducts business as an agent or intermediary of a foreign bank only outside Japan, this capital ties requirement under the BA no longer applies.

4. Tightening of Regulations on Foreign Bank Branches

The following statutory revisions on the regulations on Japanese branches of foreign banks have been made in the Amendments:

(1) Clarification of the supervisory guidelines for foreign bank branches

In order to ensure the soundness of foreign bank branches, the FSA has clarified its supervisory guidelines regarding matters to be monitored such as the circumstances of fund transfers within the foreign bank group, including transfers to and from its head offices and branch accounts, the foreign bank branch's assets in Japan, deposit types provided by the foreign bank branch and the foreign bank branch's manner of treating deposits in Japan. The FSA also clarified that these points of consideration are applicable to not only criteria for licensing but also the daily monitoring for foreign bank branches.

(2) Obligation to maintain assets in Japan

Foreign bank branches are now required to maintain assets equal to the minimum capital amount of domestic banks (2 billion yen) at all times in Japan. The following transitional measures period has been set, and foreign bank branches will be required to maintain:

(a) (From April 1, 2014 to March 31, 2015)
The larger of (i) 1.0 billion yen and (ii) the earned surplus reserve on the balance sheet as of March 31, 2014. If the earned surplus reserve exceeds 2.0 billion yen, the required amount should be 2.0 billion yen.

(b) (From April 1, 2015 to March 31, 2016)
The larger of (i) 1.5 billion yen and (ii) the earned surplus reserve on the balance sheet on March 31, 2014. If the earned surplus reserve exceeds 2.0 billion yen, the required amount should be 2.0 billion yen.

(3) Greater obligation to provide information to customers

Foreign bank branches are now also required to explain the following matters to customers:

(a) Deposits in foreign bank branches are not covered by the deposit insurance system of Japan;
(b) A foreign bank branch's solvency means the solvency of the entire foreign bank entity and the relevant supervisory authorities of the foreign bank branch's home country shall bear the primary responsibility for the supervision of the solvency (financial soundness) of the foreign bank which operates the relevant foreign bank branch;
(c) Even if a refund may be paid through the insolvency procedure in home country after the foreign bank's failure, there is the possibility that the deposits will not be refunded promptly; and
(d) If deposits are covered by the deposit insurance system of the foreign bank's home country, the facts and details of such deposit insurance system.

(4) More severe penalties for breach of an order to maintain assets in Japan

The penalty for breach of an order, which may be issued by the FSA to a bank (including a foreign bank branch) for the purposes of protecting depositors in Japan and the public interest, to maintain assets in Japan has now been augmented to imprisonment with work for a period of up to 1 year or a fine of not more than 3 million yen.

5. Tightening of Large Exposure Limits

(This amendment will be effective within one and a half years from June 19, 2013.)

Large exposure rules under the BA set an upper limit on the total amount of credit exposure to a single counterparty or a group of connected counterparties[4]. To be consistent with the international standards countenanced under "The Basel Core Principles" (published by the Basel Committee) and to respond to the calls for reinforcement by the IMF FSAP (Financial Sector Assessment Program), the Amendments aim to tighten the existing large exposure rules.

According to the summaries of the Amendments and expected revised articles of the BA, both of which were disclosed to the public[5], the major points that will be amended are as follows.

[4] The large exposure rules under the BA are not enforced to foreign bank branches.
[5] The revised article draft of subordinate regulations, which will provide the details of the revised large exposure rules, has not been disclosed yet.

(1) Scope of exposure

All asset items on the banks' balance sheets will be, in principle, subject to large exposure rules. After the effective date of this amendment, the various sums and amounts such as in the items below will be also subject to the revised rules, in addition to typical credit amounts such as loans or guarantee amounts.

- undrawn amounts in commitment line transactions
- interbank transaction amounts (including call loan amounts) and deposit amounts to other financial institutions
- publicly offered bond amounts
- trading account balances in banks
- amount equivalent to credit risk in derivative transactions

(2) Scope of aggregation

Under the current framework, to calculate the overall exposure of a consolidated companies group (as a debtor group), only exposure from subsidiaries that have more than 50 per cent of their voting rights held by a company and/or the company's subsidiaries is added. Following the Amendments, this calculation will be changed such that exposure from both the following categories of company will be added: (i) subsidiaries that have more than 50 per cent of their voting rights held by a company and/or the company's subsidiaries; (ii) subsidiaries consolidated under the actual control power standard (such as where the parent company holds 40 per cent or more of the voting rights and controls effectively through personnel, funds or transactions by another company); and (iii) affiliate companies.

Additionally, the Amendments will establish safeguards that prevent any evasion of regulations, such as by means of the use of multiple names or circumventive financing.

(3) Calculation method for exposure

Concerning on balance sheet items, amounts on balance sheets are recognized as exposure and certain prescribed item amounts such as collateral government bonds or deposit collateral are deducted. The Amendments will add off balance items, such as undrawn amounts in commitment line transactions or amount equivalent to credit risk in derivative transactions mentioned above at (i), to the calculation of exposure, and with respect to these, the calculation method for the amount equivalent to credit risk under the capital ratio regulation will be adopted following the Amendments.

(4) Lowering of limits for a debtor group

Following the Amendments, the exposure limit of a consolidated companies group (as a debtor group) will be lowered to 25 per cent from the current 40 per cent.

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Contact Information:

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