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Legal and regulatory areas of concern come and go in their perceived importance. It is, however, very difficult to recall any other occasion when a subject regarded by many lawyers as so obscure and arcane as international banking regulation has come to such prominence in such a short period of time.

Before the onset of the financial crisis in western economies in 2007, banking regulation was regarded by many as a discipline practised by technocrats who were, to put it politely, best left to themselves. The subject has risen up the agenda so quickly since then that few lawyers who advise financial institutions have had time to draw breath and assess the position now reached. The reality, of course, is that no final position has been reached and none is ever likely to be reached: banking regulation will continue to evolve, punctuated by bursts of activity every time there is a serious crisis to manage. What has happened is that the importance of this subject, and its rightful place amongst legal disciplines, has finally been recognised. This means that there is now great demand, from the banks themselves, but also from governments and regulators, for accessible and user-friendly explanations of the applicable rules.

The continual evolution of the rules makes any survey of banking regulation very difficult to write without risking almost immediate obsolescence. This book is an attempt to rise to that challenge and it is hoped that future editions will address the many further developments in this area that are expected to take place in the coming months and years. The book is aimed principally at lawyers and others who need access to an overview of the applicable rules in the important areas that the book covers and a commentary on recent developments. It also includes commentary on many of the areas of banking regulation that are of critical importance to the major cross-border transactions in which banks become involved.
The book illustrates the many and differing approaches that governments and banking regulators have taken to addressing what they perceive to be the problems affecting the banks that they regulate. To that extent, the lack of international coordination is a potential source of dismay amongst politicians and others who have spent so much time over the past three years trying to develop common approaches to the international challenges highlighted by the financial crisis.

It is, however, to be hoped that surveys of the kind in this book also inform the continuing debate about how to minimise the risk of a further crisis on anything like the scale that we have just seen. It will, quite literally, pay for governments to appreciate that further significant financial crises are inevitable in the future, and that the principal aim of reform should, therefore, be to minimise their likely impact, both on the lives of the millions of people who rely on banks and on local and regional economies.

It is a tribute both to the contributors and the publishers that so many leading banking and regulatory lawyers have made themselves available to write chapters for this book. I would like to thank them all for the support and encouragement that they have provided at a time when many of them have been almost overwhelmed with work on other projects emerging from the financial crisis. Many of the contributors have also been involved in initiatives designed to stabilise and reform the banking sectors in their countries. I would also like to thank Gideon Roberton and his colleagues at the publishers for their efforts in coordinating the project that this book has become, and in bringing it to fruition.

Jan Putnis
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Chapter 13

JAPAN

Hirohito Akagami and Toshinori Yagi*

I  INTRODUCTION

As the world’s second largest economy, Japan has a well-developed banking industry of more than 200 banks. As a result of several mergers among the larger banks before 2005, there are currently four ‘mega’ banking groups: Mizuho, Sumitomo Mitsui, Mitsubishi UFJ and Resona. A further two large banks – Sumitomo Trust and Chuo Mitsui Trust – will merge in April 2011. Approximately half of these 200 banks are so-called ‘local banks’, which provide more locally-based banking services (principally in one or more specific prefectures). There are also around five internet banks providing services solely via the internet, and approximately 60 overseas bank branches.

Japan Post Bank, with ¥180 trillion of deposits, was formerly part of the Japanese government’s postal division, and accepted deposits via its network of post offices scattered throughout the country. The bank, which is wholly owned by the Japanese government at this time, is in the process of privatisation. This process began in 2003 and was expected to be completed by 2017 by way of an initial public offering. However, this plan has been partially suspended following the change in administration after the elections in August 2009, and the privatisation plan is being reconsidered by the current administration.

II  THE REGULATORY REGIME APPLICABLE TO BANKS

i  The Banking Act and the Financial Instruments and Exchange Act

The principal source of regulation for banks engaging in business in Japan is the Banking Act (Act No. 59 of 1981), to which all banks are subject. This regulates their corporate

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Japan
governance, banking business and capital adequacy as well as their principal shareholders
(‘the bank principal shareholders’) and subsidiaries. The Banking Act also regulates
holding companies that have banks as subsidiaries (‘the bank holding companies’).

An important note is that the Japanese regulatory framework regulates so-called
commercial banking activities and investment banking activities separately. The Banking
Act is, in principle, applicable only to the former activities of banks (i.e., (1) acceptance
of deposits, (2) provision of loans and (3) transfer of funds: ‘the core banking business’).
A large number of banks also engage in investment banking activities, which generally
include securities and derivatives-related businesses. These activities are subject to
separate restrictions discussed at (iii), infra, and these banks are concurrently regulated
under the Financial Instruments and Exchange Act (Act No. 25 of 1948 – ‘the FIEA’)
for this purpose. Some banks also have affiliate securities companies engaging in the
investment banking business, and these companies are also regulated by the FIEA.

ii Regulators
The principal regulator of the banking industry is the Financial Services Agency of
Japan (‘the FSA’), whose authority to supervise banks in Japan is delegated by the Prime
Minister. The Commissioner of the FSA also delegates a part of its authority to the
directors of local finance bureaux in relation to local banks and the supervision of
investment banking activities. The on-site and off-site inspection of investment banking
activities is performed by the Securities and Exchange Surveillance Commission. The
Bank of Japan (‘BoJ’) also has supervisory authority over banks, based primarily on its
contractual agreements and transactions with them.

The regulator’s powers as prescribed in the Banking Act include receipt of various
reports, the ability to carry out on-site inspections (where a bank must, in practice,
disclose any and all information it holds to the regulator) and the power to make orders
of business improvement and suspension.

iii Entry into banking industries
Two organisational structures are available to overseas banks for establishing a core banking
business in Japan. One scheme consists of the establishment of a joint stock company with
limited liability in Japan as a subsidiary or affiliate in accordance with the Companies Act
of Japan (Act No. 86 of 2005). This subsidiary or affiliate must obtain a banking licence
from the Prime Minister of Japan, pursuant to the Banking Act (a ‘local entity bank’). The
alternative consists of the establishment of branches of the foreign bank within Japan, and
obtaining a ‘foreign bank branch’ banking licence. For the foreign bank branch scheme, the
opening of subsequent branches (which are also known as sub-branches) is also subject to
prior approval from the FSA. The grant of the necessary licences and approvals is at the
discretion of the relevant authority in each instance.

To engage in investment banking activities such as a securities and derivatives
business, the bank must also be registered with the competent local finance bureau,
pursuant to the FIEA. Registered banks are generally permitted to operate a wider range
of derivatives and securities businesses, such as brokerage of Japanese government bonds
and sales of unit trusts or non-discretionary investment advisory services. However, for
historical reasons, banks are generally prohibited from engaging in certain categories
of securities business, including brokerage and underwriting of corporate stocks and corporate bonds, and discretionary investment management services. To conduct such activities, banks must establish a subsidiary or affiliate that is a separate legal entity, and register it pursuant to the FIEA as a financial instruments business operator.

iv Cross-border activities by overseas banks not having a branch

Overseas banks may not, in principle, enter into any part of the core banking business or investment banking business in Japan or with persons in Japan without establishing a branch and obtaining a banking licence as a foreign bank branch. Even where an overseas bank has a licensed foreign bank branch in Japan, it is generally understood that the other, unlicensed overseas branches (‘the unlicensed branches’) of the bank are prohibited from engaging in transactions, or with persons, in Japan.

In connection with this, a new regulatory framework called the ‘foreign bank agency business’ was implemented in December 2008, under which both overseas banks without a licensed foreign bank branch, and the unlicensed branches of an overseas bank, may conduct a core banking business with persons in Japan through either (1) a local entity bank within the same group, or (2) a foreign bank branch of the bank acting as an agent or intermediary. Both of these options require the local entity bank or foreign bank branch to obtain separate approval from the FSA.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Most banks have a close relationship with the regulators. We understand that the officials of the supervisory division of the FSA and local finance bureaux are each assigned to monitoring specific bank(s).

The regulators tend to focus their attention principally on appropriate management of banking businesses, maintenance of sufficient financial conditions including satisfaction of capital adequacy requirements, protection of customers, and the maintenance of robust internal control systems to ensure that the bank is always in compliance with applicable laws. It is fairly common that a bank will consult with regulators in advance of occasions when it expects to receive particular attention from regulators; for instance, if it launches a new business that is not covered clearly by existing legislation, or an issue has arisen that may affect the bank’s financial condition.

ii Management of banks

Under the Banking Act, a local entity bank must have a board of directors and accounting auditors; and also a board of corporate auditors or a subcommittee of the board of directors (comprising an audit committee, remuneration committee and appointment committee) pursuant to the Companies Act. Directors and executive officers engaging in the ordinary business of a local entity bank must have the knowledge and experience to be able to manage and control the bank appropriately, fairly and efficiently and must have ‘sufficient social credibility’ (the Banking Act requires a bank to appoint directors who are trusted within society; however, what precisely is meant by this criterion is somewhat ambiguous). For local entity banks that have a board of corporate auditors,
the representative director shall take command of the establishment and maintenance of the internal compliance framework, make risk management a primary concern, establish a sufficient internal control framework to properly disclose the bank’s corporate information to the public, and ensure that appropriate internal audits are performed. The board of directors must proactively oversee the representative directors, establish and review business management plans in line with the bank’s business objectives, establish a clear risk management policy by taking these objectives into consideration, and ensure appropriate performance and review of internal audits.

For foreign bank branches, although there is no required specific corporate governance structure such as for local entity banks, the branch manager must also have the knowledge and experience to manage and control the branch appropriately, fairly and efficiently, and must also have sufficient social credibility (as referred to above). In addition, officers with sufficient knowledge and experience must be appointed to manage the branch, and the proper authority to do so must be delegated to those officers by the overseas head office. Of course, the head office is likely to wish to oversee the management of the branch, and it is permissible that it offer supervision and guidance. Therefore, it may be advisable to introduce appropriate systems for such oversight and approvals; for example, that any problematic issues occurring within the branch should immediately be reported to the head office as well as to the regulatory authority.

In addition, however, it must be kept in mind that oversight by the overseas branch or holding company must not undermine the governance framework, and the management responsibility for such, which must be established within the local entity bank or foreign bank branch to manage its business properly as a licensed financial institution. Administrative action (in the form of an order of suspension of a part of the business and an order of improvement of the business) taken against a local entity bank subsidiary of a US-based bank group illustrates the FSA’s position on how each financial institution within the same group should be managed. An FSA press release dated 27 January 2006 regarding its action states that the US parent appointed a person who had no directorship of the local entity bank but was given the title of ‘Representative in Japan’, and gave that person the primary management and control of the businesses of the local entity bank. This thereby undermined the authority and responsibility of each director of the local entity bank (despite the fact that such authority and responsibility is required under Japanese corporation law and the Banking Act). The FSA ordered the creation and development of ‘independent’ governance and internal control systems, and the establishment of a clear system of responsibility within the local entity bank, predicated upon a fundamental re-evaluation of the present state of managerial involvement and monitoring of the bank by the US parent.

iii Regulatory capital

The framework for regulating local entity banks’ capital adequacy under the Banking Act has been amended in line with the implementation of Basel II. By March 2008, the regulatory framework of Basel II had been fully introduced into Japanese banking laws through amendments of the FSA guidelines including, among other things, the internal ratings based approach (IRB approach) and the advanced measurement approach (see below). Local entity banks are now permitted to employ, following approval by the FSA
and the satisfaction of certain other conditions, an IRB approach that enables them to rely on their own measurements of counterparties’ credit risks to determine their capital requirements (subject to strict data, validation and operational requirements). Of the IRB approaches, there are two subcategories: a foundation approach and an advanced approach. Local entity banks may now use not only the former approach but also the latter approach. This permits them to use their own measurements not only to estimate the possibility of default but also the loss which may be incurred in the event of default, amongst other things.

Local entity banks with international operations must have a minimum risk-adjusted capital ratio of 8 per cent, calculated in accordance with the internationally-adopted standards under the Basel II framework, on both a consolidated and non-consolidated basis. Those banks without international operations are required to have a minimum risk-adjusted capital ratio of 4 per cent (on both a non-consolidated and consolidated basis). This is calculated in accordance with the domestic capital adequacy requirements, which are similar to those for banks with international operations. However, local entity banks employing the IRB approach must still maintain a capital ratio of 8 per cent. Similar capital adequacy regulations are also imposed on bank holding companies.

The status of the capital adequacy of banks, including the risk-adjusted capital ratio, must be reported and disclosed on a semi-annual basis. If a bank’s capital ratio falls short of the minimum above, the FSA may require the bank to prepare and implement a capital reform plan. In extreme cases, it may reduce the bank’s assets, restrict the increase of its assets, prohibit the acceptance of deposits, or take any other measures it deems necessary.

The above regulatory capital framework does not apply to foreign bank branches, on the grounds that the capital adequacy of these banks must be reviewed by their principal overseas regulators.

It should be noted that on occasion, a large-sized transaction with any one bank may be restricted due to the ‘large lending limit regulation’. Pursuant to this regulation, aggregate exposure of a local entity bank to a single person (including that person’s group companies) by means of extending loans, purchasing debt instruments or equity investments, shall not exceed, in principle, 40 per cent of the amount of non-consolidated regulatory capital (with certain adjustments) of the local entity bank.

**IV CONDUCT OF BUSINESS**

The Banking Act obliges banks to carry on their business in compliance with various regulations including a prohibition on abuse of a dominant bargaining position; management of conflict of interests; provision of explanation of risks associated with their products and other information to customers; and appropriate handling of personal information.

However, Japanese banking laws do not provide such comprehensive and strict banking confidentiality frameworks as those adopted in some jurisdictions. Questions of how and to what extent banks should protect and/or use their customers’ information have been governed by general confidentiality laws and contractual arrangements between banks and their customers (including implicit agreements), the contents of
which have been clarified and developed by court decisions made upon individual lawsuits alleging misconduct on the part of the relevant bank and by discussion within the banking industry.

The handling of customer information of individual clients is mainly governed by a general law applicable to all industries, entitled the Personal Information Protection Act of Japan (Act No. 57 of 2003 – ‘the PIPA’), although general principles thereof have been brought into the Banking Act. Under the PIPA, personal information may not, in general, be disclosed to third parties without the relevant individual’s consent or providing that individual with the right to prohibit the disclosure (an ‘opt-out’ system).

How banks should treat information held on corporate clients is discussed in the Study Group Report on Desirable Sharing of Corporate Customer Information between Banking and Securities Businesses published by the Japanese Bankers Association on 15 April 2008. This suggests that such information may be disclosed when (1) the explicit or implicit consent of the customer has been obtained, (2) the information is public information or (3) the disclosure may be deemed legitimate, taking its necessity into account (leading to the conclusion that a rather wider range of disclosure to other companies within the same group for the purpose of, for instance, marketing activities, is permissible without the client’s consent).

However, it should be pointed out that banks may disclose the confidential information of both individual and corporate clients to Japanese governmental authorities without their consent, if it is deemed necessary and appropriate. This could also apply to foreign governmental authorities, but this may not necessarily be the case (for instance, the PIPA provides that it is permitted to disclose personal information if such disclosure is ‘based on laws’, and the term ‘laws’ for this purpose is interpreted to mean Japanese law only).

V FUNDING

Substantially all types of funding methods, including equity and debt financing, call loans, repurchase transactions and central bank funding principally by way of open market operations, are available to banks.

In line with the current trend of emphasis on banks’ capital adequacy, a large number of local entity banks and bank holding companies recently conducted capital increases through public offerings. During the fiscal year ending March 2010, capital increases of approximately ¥1,800 billion, ¥1,000 billion and ¥500 billion on aggregate were conducted through public offerings by Sumitomo Mitsui, Mitsubishi UFJ and Mizuho, respectively. Straight (plain vanilla) bonds/notes and tier 1 eligible hybrid debt capital instruments are also commonly adopted as funding methods.

Open market operations are provided by the BoJ. Both local entity banks and foreign bank branches may participate, to the extent they satisfy certain requirements prescribed by the BoJ.
VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

Control regime
Shareholders of local entity banks may be subject to regulation pursuant to the Banking Act if they qualify as a 'bank principal shareholder' or 'bank holding company'.

A bank principal shareholder is generally defined as a shareholder having 20 per cent (or, in certain cases, 15 per cent) or more of the voting rights of a local entity bank. A holding company is defined as a company which has paid an acquisition price for its Japanese subsidiaries' shares exceeding 50 per cent of the total assets of the company, and which holds more than 50 per cent of the voting rights in a local entity bank. Once the shareholder qualifies as a bank holding company, it will be subject to regulations applicable to a bank holding company rather than a bank principal shareholder.

Any person who wishes to become a bank principal shareholder must obtain prior approval from the FSA. A bank principal shareholder may be required by the FSA to submit reports or materials, be inspected by the FSA at its offices and have to answer questions put by an FSA officer, and have to present accounting books and other documents. If a bank principal shareholder fails to satisfy any conditions given by the FSA in conjunction with the approval, the FSA may order the bank principal shareholder to take any actions the FSA considers necessary. Further, a bank principal shareholder having more than 50 per cent of the voting shares of a local entity bank may be ordered by the FSA to submit an improvement plan or otherwise take necessary measures to ensure the sound and appropriate management and operation of the local entity bank. ‘Necessary measures’ is interpreted to include certain kinds of ‘keep well’ directions aimed at the local entity bank, for instance, capital support to the local entity bank if it has any problems with capital adequacy.

The regulations applicable to a bank principal shareholder are generally applicable in the same way to a bank holding company. Improvement plans and ‘keep well’ directions are also applicable to both. Further, the scope of business of a bank holding company and its subsidiaries is restricted to certain financial businesses. The maximum amount of credit that may be extended to a single group of persons by a bank holding company and its subsidiaries is the amount calculated in accordance with a formula specified in the Banking Act.

Transfers of banking business
Local entity banks may transfer their banking businesses in one of three ways: (1) a business transfer for all or part of the bank’s business, (2) a corporate merger of the whole business or (3) a corporate split for part of its business. For foreign bank branches, the business transfer is commonly used to amalgamate the Japanese operations of two or more foreign banks. Other procedures of transfer may also be available pursuant to the laws of their home countries, but there is some ambiguity in how the special procedures required under the Banking Act to protect customers will apply to transfers conducted pursuant to foreign laws. Both local entity banks and foreign bank branches may be a transferee of the banking business of another bank. A banking business cannot be transferred to an entity other than a bank unless that entity obtains a banking license prior to the closing of the transfer.
i  Business transfer

In summary, the procedure for a business transfer under the Banking Act is: (1) the execution of the business transfer agreement between the transferor and transferee; (2) in case of a transfer of a whole business, the completion of procedures for the creditors’ protection (among other procedures); (3) application to the FSA by both the transferor and the transferee for approval of the business transfer; and (4) after approval has been obtained, closing can take place. Step (2) is performed by way of publishing a notice over a period of at least one month to creditors of the effect of the business transfer. This step essentially enables the transferor bank to replace individual consents (as would usually be required under the Civil Code) with the public notice.

ii  Corporate split and corporate merger

Corporate split and corporate merger procedures are similar to that of a business transfer: (1) the execution of the corporate split/corporate merger agreement; (2) procedures for creditors’ protection as above; (3) application for approval from the FSA; and (4) the closing after FSA approval has been obtained. Step (2) must also be performed by way of making a public notice to creditors. By application of the provisions of the Companies Act, all contractual relationships pertaining to the transferred business are transferred to the transferee bank without individual consent of the counterparties. All of the relevant steps required under the Companies Act and securities laws, as well as the rules of securities exchanges, remain applicable under these procedures.

VII  THE YEAR IN REVIEW

i  Relaxation of ‘firewall’ regulation and conflict of interest management

For the purpose of ensuring the separation of investment banking businesses and commercial banking businesses as mentioned above, there is a restriction on information sharing between securities firms and their group companies (‘the firewall regulation’). Before June of 2009, under the firewall regulation then in effect, a securities firm was prohibited from sharing customer information with its group companies (including affiliate banks and other financial institutions) without the written consent of the customer, and ‘dual-hatting’ of officers and personnel among these companies was generally prohibited (dual-hatting being the exercising by one person, of roles in both types of business). The only statutory exemptions were information sharing and dual-hatting for the purpose of internal controls, and maintenance and operation of IT systems (which were permitted following approval from the FSA).

The amendment to the FIEA and subordinated regulations which came into effect in June 2009 relaxed the firewall regulation to some extent. Although the prohibition of information sharing without customer consent still exists, the amendment enables a securities firm to deem a customer’s written consent if it submits a notice to the customer and does not receive an objection to information sharing (an ‘opt-out’ system). The prohibition on dual-hatting has also been generally abolished. Now the officers and personnel of a securities firm may concurrently work for its affiliate bank, subject to compliance with any other applicable regulations. This should enable financial institutions to provide a wider range of financial services to customers.
The same amendments require all banks and certain other financial institutions (including securities firms and insurance companies) to establish an internal framework for the appropriate management of potential or actual conflicts of interests, which may arise in relation to services provided by the financial institutions or their affiliates on a group-wide basis.

**ii Moratorium Act**

The Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises, etc. (Act No. 96 of 2009 – ‘the Moratorium Act’) came into force in December 2009. The Moratorium Act requires local entity banks to (1) endeavour on a ‘best-efforts’ basis to provide new credit to small and medium-sized enterprises (‘SMEs’); (2) endeavour on a ‘best-efforts’ basis to take steps to alleviate the burden of debt, upon receipt of a request for the postponement of repayment of debt by an SME or a borrower of a residential mortgage; (3) establish a framework to give effect to the steps described in (2); and (4) to disclose and report to the authorities the steps taken in connection with (2) and (3). In connection with this, amendments were also made to the guidelines the FSA uses in supervising financial institutions, and to its manuals for conducting inspections of financial institutions. The FSA seems to be conducting supervision with a view to encouraging local entity banks to extend more credit to SMEs and to treat the postponement of repayment of debt in a more positive manner. Also owing to these amendments, it has been made easier for banks to relax the conditions on loans to SMEs. It should, however, be pointed out that there is a possibility that these measures could have a negative effect on the balance sheet of local entity banks.

**iii Payment Services Act**

As mentioned previously, funds transfer services constitute part of the core banking business, and are a service that has been dominated previously by licensed banks. The Payment Services Act, which came into force on 1 April 2010, however, permits fund transfers not exceeding ¥1 million to be engaged in by those other than licensed banks, with simpler regulations. It is expected that businesses from a wider range of industries, including mobile phone carriers and internet service providers, may enter this sector as a result.

**VIII OUTLOOK AND CONCLUSIONS**

For more than a decade, the Japanese government has proceeded with a relaxation of regulations on financial institutions, aiming to increase the competitiveness of Japan’s financial industries. However, in step with the worldwide movement to impose tougher constraints on the financial sector following the bankruptcy of Lehman Brothers, the Japanese government seems also to be turning to stricter regulation. For instance, legislation for partial amendment to the FIEA promulgated in May 2010 includes, among other things, a new regulatory framework on settlement and clearing of OTC derivatives transactions (for example, the establishment of a central counterparty (‘CCP’) in interest and credit default swaps) and a new group-wide supervisory framework for securities companies.
Given the change in government in August 2009 from the Liberal Democratic Party (which had held power in Japan almost continuously since the 1950s), to a coalition led by the Democratic Party of Japan, it has become more difficult to predict the direction of banking regulation policies, particularly when coupled with the changes in financial regulatory environments worldwide. All participants in the Japanese banking industry are strongly recommended to observe closely any trends and changes in Japan’s financial regulations.
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