# The Banking Regulation Review

Fourth Edition

Editor
Jan Putnis

Law Business Research

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# The Banking Regulation Review

Fourth Edition

Editor
Jan Putnis

Law Business Research Ltd

# THE LAW REVIEWS

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# EDITOR'S PREFACE

2012 may be remembered as the year when practical reality caught up with those who thought that the financial crisis that emerged in Western economies in 2007 would result in more effective cooperation between financial regulators across the world. By one measure – the number of new initiatives and proposals for reform – the amount of cross-border financial regulatory activism has never been higher. But by more useful measures – moves towards solutions to the 'too big to fail' problem through the development of effective cross-border resolution mechanisms for banking groups and international cooperation on reform of OTC derivatives regulation – the optimism of the past has faded a little.

Questions are increasingly asked about whether the obstacles to truly productive cross-border regulatory cooperation – political imperatives, different incentives and straightforward differences of view – will ever be surmounted in ways that make international banking groups fundamentally safer. Media speculation in January 2013 that US regulators might not allow banks to assume cross-border regulatory cooperation in the resolution plans that they prepare in 2013 would, if substantiated, highlight this trend.

These apparently negative developments have not made the period since the publication of the last edition of this book in April 2012 any less interesting. It is also worth noting that most of the challenges that we have seen – new law and regulation that creates difficult questions of cross-border consistency and extraterritoriality, differing regulatory philosophies between major financial jurisdictions and the sheer slowness and unpredictability of developments – have rational, if depressing, explanations. For example, fundamental differences between the insolvency law of major jurisdictions, coupled with cross-border recognition issues and disagreements over how to pay for resolution, are nothing if not formidable barriers to the development of workable group-wide resolution plans for banking groups.

However, the past 12 months have not been a period of complete failure of regulatory reform either. Progress has been made, for example, in the enactment of legislation regarding OTC derivatives, most notably the European Market Infrastructure

Regulation (EMIR) in the European Union. But, as noted above, cross-border cooperation in this area remains an issue: it seems that hardly a month goes by without the discovery of a previously unremarked-upon anomaly between the rules in this area in different countries.

Bank liquidity regulation has continued to be the subject of intense debate in 2012, culminating in the Basel Committee's announcement in January 2013 of its decision to relax and to recommend the gradual phasing in of the liquidity coverage ratio ('LCR') for banks. Taking into account the fundamental influence that the LCR will have on many banks' business models, this was a welcome sign of pragmatism and also a sign of the Basel Committee's willingness to move the debate on liquidity forward.

Despite the challenges that have arisen in bank resolution initiatives, legislation and rules are developing in this area in multiple jurisdictions, with, for example, the publication of the draft European Union Recovery and Resolution Directive ('the RRD') in June 2012.

The European Union is, at the time of writing, enjoying a period of respite from the problems that it faced from the eurozone crisis in 2012, but it would be very optimistic to say that those problems have been brought under control. The European Commission is placing much emphasis on finalising the legislation implementing Basel III (CRD IV) and the RRD as soon as possible in 2013, notwithstanding that each of these initiatives may ultimately be affected profoundly by the parallel 'banking union' proposals for the eurozone.

In the United States, the main rules implementing Basel III are also expected to be substantially finalised in 2013. The significance of the restructuring of the financial regulatory regime in the United States, principally under the rules that are emerging from the framework established by the Dodd-Frank Act, continues to unfold and looks set to dominate the careers of a generation of regulators, bankers and their advisers.

The realisation dawned on many banks in 2012 that regulatory reform will be a longer and more drawn-out process than had been anticipated. For this reason, 2012 may also be remembered as the year when the banking sector in Europe, the United States and some other parts of the world began to think seriously about structural change in the long term, accepting that restructuring will have to take place against a backdrop of continuing regulatory reform. We have begun to see more group reorganisations, disposals, and the severe downsizing or closure of some businesses in banking groups, as well as opportunistic acquisitions. Four principal factors have contributed to these developments:

*a* A little more certainty, or at least the perception of a little more certainty, about rule-making (or, at least, the direction of rule-making) when compared to the past.

*b* The continuing urgent need that many banking groups have for capital and liquidity, and the related need to ensure that capital is deployed in the most efficient and profitable ways.

*c* Some specific legal and regulatory initiatives driving structural change, such as the US Volcker Rule (although this rule has not yet been fully defined at the time of writing) and some emerging (though not yet in force) 'ring-fencing' proposals in parts of Europe (so far principally in the United Kingdom and France).

*d* Continuing regulatory attacks on complexity and actual or perceived barriers to resolution of banking groups.

Accordingly, many banks are refocusing their businesses (or are currently planning how to do so) on what they consider to be the areas that will yield the highest returns relative to cost in regulatory capital and liquidity terms. Consistent with that objective, we are seeing intense competition for capital allocation between different businesses within banking groups and a more widespread appreciation of the relative capital cost (or capital efficiency) of different activities.

2012 was of course also marked by further recrimination about past practices in parts of the banking sector. Allegations that LIBOR and other benchmarks have been manipulated (or subject to attempted manipulation), continuing losses from mis-selling and other past misconduct continue to affect the sector. Attention has turned more recently to the ways in which banking groups quantify and present these problems in their financial statements.

An increasingly orthodox view among senior management of banking groups in Europe and the United States is to conclude that the only way through these difficulties is to adopt a 'whiter than white' approach to compliance. This involves banks taking the initiative to present a new way forward on compliance matters and breaking away from the more reactive stance that some of them held in the past. Some commentators have asked where this will lead. Will it result in banking groups that are so hobbled and diminished by internal policies and rules that innovation, efficiency and, ultimately, service to the 'real' economy, is put at risk? Observation would suggest that this is a concern unless banks keep in mind four critical objectives when developing their compliance strategy and relationships with financial regulators:

***Compliance***

The first and most obvious objective is to ensure that banking groups are and remain compliant with their legal and regulatory obligations. In many countries this involves developing a good understanding of the purpose and spirit of those obligations in addition to (or, in some cases, instead of) their literal meaning.

***Predictability***

It is desirable to maximise the predictability of relationships with financial regulators. Good and constructive relationships with regulators generally make it more likely that banks will see what is coming around the corner sooner and will be better able to find positive ways to plan ahead.

***Influence***

Constructive influence of regulatory policy development in areas affecting banks is also desirable, even if a bank achieves no more than a small proportion of the change that it would like to see. For this purpose I would include within the meaning of 'influence' the conveying of cogent arguments even where regulators do not act in response to them. This is simply because the route to influence for a bank includes convincing regulators that it has thoughtful and coherent ideas, even where political or other imperatives have the result that the regulator does not address the bank's concerns.

***Flexibility and pragmatism***
Flexibility and pragmatism in the relationships between banks and their regulators is critical. Inflexibility can lead to inappropriate or overly formulaic regulatory approaches to unexpected developments. Flexibility is often difficult to achieve but is worth pursuing in the interests of both banks and regulators, through regular informal contacts and exchanges of views with senior staff at regulators in addition to formal interactions.

Obvious-looking these objectives may be, but serious problems in relationships between banks and their regulators can usually be traced back to a failure to achieve at least one of them.

This updated edition contains submissions by authors provided for the most part between mid-January and mid-February 2013, covering 56 countries (in addition to the chapters on International Initiatives and the European Union). As ever, comments on this book from banks, regulators and governments are welcome.

My thanks go to the contributors to this book, who have once again taken time out from advising on important matters affecting the banking sector to update their chapters – 'update' meaning a fundamental revision in many cases.

Thanks are also due to Adam Myers, Lydia Gerges and Gideon Roberton at Law Business Research Ltd, for their continuing support in the preparation of this book.

Finally, the list of credits would not be complete without mention of the partners and staff of Slaughter and May, in particular Ruth Fox, Ben Kingsley, Peter Lake, Laurence Rudge, Nick Bonsall, Ben Hammond, Tolek Petch and Michael Sholem. Once again, they helped not only to make this book possible but also to keep it as painless a project as is currently possible in the field of banking regulation.

**Jan Putnis**
Slaughter and May
London
March 2013

## Chapter 29

# JAPAN

*Hirohito Akagami and Wataru Ishii*[1]

## I INTRODUCTION

As the world's third-largest economy, Japan has a well-developed banking industry of approximately 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 – merged in April 2011. Approximately half of these 200 banks are 'local banks', which provide more locally based banking services (principally in one or more specific prefectures). There are also around six internet banks providing services solely via the internet, and approximately 60 overseas bank branches.

Japan Post Bank, with ¥175 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. Pursuant to this, the shares in the bank will, taking into consideration respectively the business conditions of the bank and the responsibilities of the affiliate companies of the bank, be disposed of as soon as possible in accordance with the relevant laws and regulations.

## 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 governance, banking business and capital adequacy as well as their principal shareholders

1 Hirohito Akagami is a partner and Wataru Ishii is an associate at Anderson Mōri & Tomotsune.

('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 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 Section II.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 ('FSA'), whose authority to supervise banks in Japan is delegated by the Prime Minister. The Commissioner of the FSA also delegates a part of his authority to the directors of local finance bureaus 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.[2] 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,

2 Article 47-2 of the Banking Act.

pursuant to the FIEA.[3] 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.[4] 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 ('FIBO').

### 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 a local entity bank within the same group, or 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.[5]

## 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 bureaus are each assigned to monitoring specific banks.

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.

3 Article 33-2 of the FIEA.

4 Article 33 of the FIEA.

5 Chapter 7-2 of the Banking Act.

### 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.[6] 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 ambiguous).[7] 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.[8] 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.[9]

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 for it to 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

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6 Article 4-2 of the Banking Act.

7 Article 7-2 of the Banking Act.

8 III-1-2-1 (1) of 'Comprehensive Guidelines for Supervision of Major Banks, etc.' of the FSA ('the FSA Supervisory Guidelines').

9 III-1-2-1 (2) of the FSA Supervisory Guidelines.

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.

There is no express provision under the Banking Act that directly restricts the amount, form and manner of remuneration paid to the management or employees of banks or their affiliates. However, the regulators have been placing greater emphasis on ensuring appropriate remuneration in light of the need to avoid excessive risk-taking and to conform with the consensus of the Financial Stability Board. More specifically, as part of general prudential regulations, banks are expected to (1) have an independent committee or other type of organisation to sufficiently monitor the remuneration of management and employees; (2) ensure financial sufficiency, appropriate risk control, consistency between incentive bonuses and actual performance (i.e., the level of incentive bonuses should substantially decrease in the event of the bank's poor financial performance) and contribution to long-term profits in determining remuneration structures; and (3) disclose important matters regarding remuneration.[10]

### iii Regulatory capital and liquidity

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 administrative notice[11] including, *inter alia*, 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 that may be incurred in the event of default, *inter alia*.

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

10 III-2-3-5 of the FSA Supervisory Guidelines.

11 FSA administrative notices No. 19 of 2006 and No. 20 of 2006.

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.

Capital adequacy requirements for local entity banks with international operations will be amended in line with the regulatory framework of Basel III through amendments to the FSA administrative notice, which will take effect from March 2013. The FSA administrative notice provides transitional measures for the term from 31 March 2013 to 30 March 2015 and such banks will be required to maintain a minimum common equity Tier I ratio of 4.5 per cent and Tier I ratio of 6 per cent on and after 31 March 2015 based on such amended capital adequacy requirements.[12]

The status of the capital adequacy of banks, including the risk-adjusted capital ratio, must be reported and disclosed on a semi-annual basis.[13] If a bank's capital ratio falls short of the minimum mentioned 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.[14]

The regulatory capital framework mentioned above 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 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.[15]

The Banking Act does not contain an express provision that directly regulates banks' liquidity or any quantitative standards of liquidity. However, the FSA Supervisory Guidelines provide some guidance on this point from a regulatory monitoring perspective. These guidelines require a bank, *inter alia*, to (1) establish an internal framework to appropriately control liquidity risk (e.g., by separating the treasury division from the liquidity risk control division); (2) maintain control methods as well as internal reporting procedures regarding the bank's liquidity that are subject to the approval of the board of directors; and (3) monitor the status of its liquidity and be prepared for emergency circumstances.[16]

12 FSA Administrative Notice No. 19 of 2006, as amended on 30 March 2012.

13 Article 19 of the Banking Act.

14 Article 26, Paragraph 2 of the Banking Act.

15 Article 13 of the Banking Act.

16 III-2-3-4 of the FSA Supervisory Guidelines.

The Inspection Manual for Deposit-taking Institutions, which has been prepared by the FSA for use by their inspectors, also includes detailed checklists for banks' self-regulation as part of the framework for managing liquidity risk. These requirements apply not only to local entity banks but also to foreign bank branches. For the latter, however, it is understood that there will be broad variations as what constitutes acceptable levels of, and procedures for, liquidity risk management given that the business of foreign bank branches varies greatly from one to another.

### iv Recovery and resolution

The Deposit Insurance Act (Act No. 34 of 1971) provides certain measures in case serious problems arise in the maintenance of stability of the financial systems in Japan or in regions where a bank operates its business. Such measures include capital injection, full deposit protection and temporary nationalisation. These measures may be initiated subject to deliberation by the Financial System Management Council.[17]

Capital injection is designed to allow a bank with positive net worth to increase the amount of its capital by way of having its shares subscribed by the Deposit Insurance Corporation of Japan. Full deposit protection is designed for banks with negative net worth or that suspend or may suspend the repayment of deposits. Temporary nationalisation is intended for banks with negative net worth that suspend or may suspend the repayment of deposits.

Laws and regulations for 'bail-in' powers have not yet been established in Japan.

## 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 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 – 'PIPA'), although general principles thereof have been brought into the Banking Act. Under the PIPA, personal information may not,

17 Article 102 of the Deposit Insurance Act.

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).[18]

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 years ending March 2010 and 2011, 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. In January 2011, Resona Holdings launched a global offering of its common stock of approximately ¥600 billion, the proceeds of which were used for repayment of public funds. Straight (plain vanilla) bonds/notes and Tier I 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.

18 Article 23 of the PIPA.

## VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

### i 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.[19] A bank holding company is defined as a company that has paid an acquisition price for its Japanese subsidiaries' shares exceeding 50 per cent of the total assets of the company, and that holds more than 50 per cent of the voting rights in a local entity bank.[20] 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.[21]

Any person who wishes to become a bank principal shareholder must obtain prior approval from the FSA.[22] Such person is also required to satisfy the following criteria:

*a* in light of matters concerning funds for the acquisition, the purpose of holding shares or other matters concerning the holding of shares, there must be no risk of impairment to the sound and appropriate management of the business of the bank;

*b* in light of the status of property and income and expenditure of the person and its subsidiaries, there must be no risk of impairment to the sound and appropriate management of the business of the bank; and

*c* the person must have sufficient understanding of the public nature of the business of the bank and have sufficient social credibility.[23]

A bank principal shareholder may be required by the FSA to submit reports or materials, may 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.[24] 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.[25] 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.[26] 'Necessary measures' are interpreted to include certain kinds of 'keep well' directions aimed at the local entity

19 See Article 2, Paragraph 9 of the Banking Act.

20 See Article 52-17, Paragraph 1 and Article 2, Paragraph 13 of the Banking Act.

21 Article 52-9, Paragraph 1 and Article 55, Paragraph 2 of the Banking Act.

22 Article 52-9, Paragraph 1 of the Banking Act.

23 Article 52-10 of the Banking Act.

24 Article 52-11 and 52-12 of the Banking Act.

25 Article 52-13 of the Banking Act.

26 Article 52-14 and 52-15 of the Banking Act.

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 and its shareholder.[27] 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.[28] 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.[29]

### ii 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 licence prior to the closing of the transfer.

*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);[30] (3) application to the FSA by both the transferor and the transferee for approval of the business transfer;[31] 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.[32]

27 Article 52-31 to 52-34 of the Banking Act and Article 1-7 of the Ordinance for Enforcement of the Banking Act.

28 Article 52-21, Paragraph 1, Article 52-23, Paragraph 1 of the Banking Act.

29 Article 52-22 of the Banking Act.

30 Article 34 of the Banking Act.

31 Article 30, Paragraph 3 of the Banking Act.

32 Article 34, Paragraphs 3 and 4 of the Banking Act.

*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 mentioned above;[33] (3) application for approval from the FSA;[34] 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;[35] 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 Certain OTC derivatives transactions through the electronic transaction system

Following the Leaders' Statement at the Pittsburgh Summit in September 2009, and in line with legislation in the US and EU, the 2010 FIEA Amendment introduced new regulations on over-the-counter ('OTC') derivative transactions that require banks registered under the FIEA (see Section III.iii, *supra*) as well as FIBOs to ensure that certain OTC derivative transactions are cleared through central counterparties.[36] In addition to the amendment, the 2012 FIEA Amendment, which will take effect within three years, requires banks registered under the FIEA as well as FIBOs to implement certain OTC derivative transactions (to be specified by a Cabinet Office Ordinance) through an electronic transaction system.[37]

### ii Working Group on Banking Regulations

The Working Group on Banking Regulations that Contribute to the Stability of the Financial Systems was established in the Financial System Council to deliberate regulations on branch offices of foreign banks and lending limits to single borrowers. Such deliberation may lead to further amendments of relevant laws and regulations.

## 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

33 Article 789, Paragraph 2; Article 799, Paragraph 2; Article 810, Paragraph 2; and Article 789 of the Companies Act; Article 33 and 33-2 of the Banking Act.

34 Article 30, Paragraphs 1 and 2 of the Banking Act.

35 Article 750, Paragraph 1; Article 754, Paragraph 1; Article 759, Paragraph 1; and Article 764, Paragraph 1 of the Companies Act.

36 Article 156-62 of the FIEA.

37 Article 40-7 of the FIEA.

constraints on the financial sector following the global financial crisis, the Japanese government also seems to be turning to stricter regulation.

Given the change in government in December 2012 to a coalition led by the Liberal Democratic Party (which had held power in Japan almost continuously since the 1950s until August 2009), 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 closely observe any trends and changes in Japan's financial regulations.

## Appendix 1

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