Banking Regulation

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Japan

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Introduction

Although recent developments in Japanese banking regulations are a mixture of strengthening of regulations and deregulation, they tend to be in line with the global attitudes toward banking regulation in recent years. Regarding regulations to ensure a stable financial system, the Japanese government seems to be moving in the general direction of stricter regulations after the global financial crisis. Regarding regulations to restrict banks' businesses and activities, the Japanese government has tended toward deregulation with the aim of efficiently managing banking groups and developing businesses under banking groups. Noteworthy recent developments in Japanese banking regulations include amendments of regulations in order to deal with developments in IT.

Regulatory architecture: overview of banking regulators and key regulations

Key legislation and regulations

Banking Act

The principal legislation regulating banks in Japan, including bank holding companies and foreign bank branches, is the Banking Act (Act No. 59 of 1981, as amended (**Banking Act**)). The Banking Act, together with the orders and ordinances issued thereunder, primarily govern the following matters in respect of banks: licensing; organisation and governance; business scope; customer protection; prohibited acts; capital adequacy; subsidiaries and shareholders; accounting; disclosure; and mergers and acquisitions. The Financial Services Agency of Japan (**FSA**) also issues various guidelines (**Guidelines**) concerning banking activities. Although the Guidelines do not have legal enforceability, banks in Japan are, in practice, required to comply with them.

Financial Instruments and Exchange Act

The financial regulatory framework in Japan is similar to that in the US, and does not adopt a universal banking system like the EU, although banks and bank holding companies in Japan are allowed to hold subsidiaries that provide a broad range of financial services. Banks in Japan may engage in certain securities-related services. Securities-related services that banks in Japan are allowed to provide include brokering and dealing in securities, sale of securities, underwriting of securities and derivative transactions within the prescribed scope. The key legislation regulating banks' provision of securities-related services is the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended; the **FIEA**), the orders and ordinances issued thereunder and the Guidelines.

Regulatory body

The principal regulator that exercises oversight of banks in Japan is the FSA, whose authority to supervise banks is delegated by the Prime Minister. The FSA supervises banking activities, issues banking licences, and imposes administrative sanctions on banks for wrongdoing or lack of adequate internal control systems.

Off-site monitoring and on-site inspections of banks in Japan are also primarily performed by the FSA. On the other hand, inspections in respect of banks' securities-related services are conducted by the Securities and Exchange Surveillance Commission of Japan.

Key restrictions

Licensing

No person is allowed to engage in any Banking Businesses in Japan or with a person in Japan without having first obtained a banking licence from the FSA. "**Banking Businesses**" refer to: (i) the (a) acceptance of deposits, and (b) lending of funds or discounting of bills or notes; or (ii) the conduct of exchange transactions.

There are two ways by which a foreign bank may engage in Banking Businesses in Japan. The first is to establish a local subsidiary or a local affiliate in the form of a joint-stock company (*kabushiki kaisha*). The second is to establish a foreign bank branch in Japan, and obtain a banking licence for such bank branch.

Banks in Japan are, in principle, required to obtain a licence from the FSA if they wish to provide securities-related services in Japan. Such licensing requirement is in addition to the banking licence that banks in Japan have to obtain for the provision of banking services.

Scope of business

Banks in Japan are only permitted to engage in Banking Businesses, businesses incidental to Banking Businesses, and such other businesses expressly permitted under the Banking Act and other legislation.

Limitations of holding voting rights of other companies

Under the Banking Act, local banks are, in principle, prohibited from holding more than 5% (or, in the case of bank holding companies, 15%) of the voting rights of any company in Japan other than companies engaging in certain finance-related businesses or businesses ancillary to the banking business (**5 Percent/15 Percent Rule**).

Permitted business by banks' subsidiaries and affiliates

Under the Banking Act, the types of businesses in which the subsidiaries of local banks are permitted to engage are limited to certain finance-related businesses or businesses ancillary to businesses of the banking group (**Ancillary Businesses**). Under the Guidelines, the scope of businesses of the affiliates of local banks are also restricted in the same way.

Large exposure limits

The large exposure rules under the Banking Act prescribe a limit to a bank's aggregate credit exposure to a single counterparty or a group of connected counterparties. Pursuant to this regulation, a local bank cannot have aggregate credit exposure to a single person (including that person's group companies) that exceeds, in principle, 25% of the bank's non-consolidated regulatory capital (calculated with certain adjustments).

Foreign bank branches regulations

The regulations applicable to foreign bank branches were recently tightened as follows:

- in order to ensure the soundness of foreign bank branches in Japan, the FSA clarified its supervisory guidelines with respect to 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 not only to criteria for licensing but also the daily monitoring of foreign bank branches;

- foreign bank branches in Japan are required to maintain at all times assets equal to the minimum capital amount that local banks are required to maintain (i.e., JPY 2 billion);
- foreign bank branches are now also required to explain certain matters to customers (such as the fact that deposits in foreign bank branches are not covered under Japan's deposit insurance system); and
- the penalty for breach of an order to maintain assets in Japan, which may be issued by the FSA to a bank (including a foreign bank branch) has been augmented.

Recent regulatory themes and key regulatory developments in Japan

The 2016 amendments to the Banking Act

On April 1, 2017, the amendments of the Banking Act in response to advances in information technology went into effect. A brief summary of the amendments is set forth below.

Management of a bank group

A bank holding company or an ultimate parent bank of the banking group will be required to manage its banking group by means that include: (i) the establishment and proper implementation of a group management policy, a risk management policy and a policy for the development of a crisis management system; (ii) the effective management of intra-group conflicts of interest; (iii) the development of the system to ensure that directors and employees conduct the business in compliance with applicable laws and regulations; and (iv) the establishment of a recovery plan for the group and ensuring that the plan can be implemented ((iv) is required for certain groups designated by the Commissioner of the FSA).

Aggregation of operations

Prior to the amendments, a bank holding company was only permitted to engage in the management of its subsidiaries. As a result of the amendments, a bank holding company may engage in the following operations that are common to multiple entities (which must include a bank) within the group:

- Asset management for the banks within the group.
- Negotiation of M&A for group companies.
- Credit examination for the banks within the group.
- Design, operation or maintenance of a system, and the design, development and sale of programmes for group companies.
- Lease of real estate or management of real estate and equipment thereto for group companies.
- Administration regarding company benefits for directors and employees of group companies.
- Purchase and management of office supplies for group companies.
- Lease of machinery and other equipment for group companies.
- Advertisement and promotion for group companies.
- Research and provision of information necessary for group companies.
- Development of financial products for the banks within the group to sell.

- Calculation functions for group companies.
- Preparation, organisation, storage, shipping or delivery of documents for group companies.
- Intermediary of administration between group companies and their customers.
- Education and training for directors and employees of group companies.
- Any other operations incidental to the above items.

In addition, a subsidiary of the bank holding company may delegate the operations that are common to multiple entities (which must include a bank) without supervising the outsourced function itself, on condition that the bank holding company supervises the delegated functions.

Relaxation of the Income Dependency Regulation

Prior to the amendments, a subsidiary of a local bank or a bank holding company which engages in Ancillary Businesses was required to earn (i) at least 50% of its total revenues from its affiliates in the banking group, and (ii) any revenues from the bank in the banking group (**Income Dependency Regulation**). As a result of the amendments, the Income Dependency Regulation has been relaxed in relation to subsidiaries which engage either in certain settlement activities or in Ancillary Businesses for other subsidiaries in the banking group engaged in certain financial-related businesses.

Relaxation of the arm's length rule

The Banking Act prohibits intra-group transactions within a banking group unless under arm's-length terms. As a result of the amendments, the arm's length rule will not be applied if such transaction is not likely to undermine the soundness of the bank and the bank clearly stipulates the terms of such transaction, and subject to the acquisition of approval from the Commissioner of the FSA. This relaxation is expected to facilitate intragroup fund transfers.

Facilitation of investments in FinTech companies

Local banks and bank holding companies are, in principle, subject to the 5 Percent/15 Percent Rule. As a result of the amendments, these limitations will be lifted so that a local bank or a bank holding company may acquire and hold more than 5% or 15% of the voting rights in a FinTech company, subject to the approval of the Commissioner of the FSA.

Group-wide permission for bank's agency and intermediary services

As a result of the amendments, a foreign bank may obtain the approval of the Commissioner of the FSA for agency or intermediary services on a group-wide basis in addition to individual approvals that are granted on an entity-by-entity basis.

The 2017 amendments to the Banking Act

On 3 March 2017, a bill to amend the Banking Act was submitted to the 193rd Session of the Diet. The bill was submitted with the aim of promoting affiliation and cooperation between financial institutions and FinTech companies while securing customers' protection. A brief summary of the bill, which has not yet been passed (as of April 2017) is set forth below.

Introduction of registration system for Electronic Payment Intermediate Service Providers

Currently, there is no clear legal framework for persons engaging in (i) the communication of payment instructions utilising IT, or (ii) the acquisition of account information from financial institutions and the provision of the same to customers under entrustment from customers, acting as an intermediary between financial institutions and customers (**Electronic Payment Intermediate Service Providers**; these are equivalent to Payment

Initiation Service Providers (PISP) and Account Information Service Providers (AISP) as defined in the Revised Payment Services Directive (PSD2) in force in the EU). Following the proposed amendments, a registration system for Electronic Payment Intermediate Service Providers will be introduced. Electronic Payment Intermediate Service Providers will be subject to certain financial requirements and other obligations.

Execution of contracts with financial institutions

Following the proposed amendments, an Electronic Payment Intermediate Service Provider will be required to execute a contract with a financial institution prior to engaging in its electronic payment intermediate services.

Promotion of open innovation by financial institutions

Following the proposed amendments, financial institutions will need to establish and publish standards to determine whether contracts can be executed with Electronic Payment Intermediate Service Providers. Financial institutions will be prohibited from treating Electronic Payment Intermediate Service Providers which meet the said standards in an unfair and discriminatory manner.

Financial institutions will be required to publish a policy on affiliation and cooperation between financial institutions and Electronic Payment Intermediate Service Providers within nine months from the date of the promulgation of the bill.

Financial institutions which intend to execute contracts with Electronic Payment Intermediate Service Providers will need to make efforts to develop a system that enables Open API within two years from the date of enforcement of the amendments.

Bank governance and internal controls

Under the Banking Act, a local bank must have (i) a board of directors, (ii) a board of corporate auditors, an audit and supervisory committee or nominating committee, and (iii) an accounting auditor. Directors and executive officers engaging in the ordinary business of a local 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". For local banks with a board of corporate auditors, the representative director is required to 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.

With respect to foreign bank branches, although there is no required specific corporate governance structure applicable to them as is the case for local banks, the branch manager of foreign bank branches must also have the knowledge and experience to manage and control the branch appropriately, fairly and efficiently, and must also have sufficient social credibility. 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.

There is no explicit 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. The regulators, however, 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: (i) have an independent committee or other type of organisation to sufficiently monitor the remuneration of management and employees; (ii) ensure financial sufficiency, appropriate risk control, consistency between incentive bonuses and actual performance and contribution to long-term profits in determining remuneration structures; and (iii) disclose important matters regarding remuneration.

Bank capital requirements

The framework for regulating local 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 law through amendments to the FSA administrative notice.

Local banks with international operations are required to maintain a minimum common equity Tier I ratio of 4.5% and Tier I ratio of 6% on and after 31 March 2015. This is in accordance with the FSA administrative notice, which is in line with the Basel III regulatory framework.

Local banks without international operations are required to have a core capital ratio of 4% (on both a non-consolidated and consolidated basis) from 31 March 2014, and those banks employing the IRB approach are required to have a core capital ratio of 4.5% from 31 March 2015.

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 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.

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.

Rules governing banks' relationships with their customers and other third parties

Proprietary transactions

Although banks are not prohibited from engaging in proprietary transactions, they need to be mindful of the following regulations:

(i) Insider trading

The FIEA prohibits the sale and purchase of the securities of an entity listed on a securities exchange in Japan by (a) persons affiliated with the listed entity, and (b) persons who have received information from those affiliated with the listed entity and who therefore know or have access to significant insider information concerning the securities of the listed entity prior to the disclosure of such information.

(ii) Short selling

Naked short selling of securities is prohibited in principle, and certain short selling that exceeds the amount prescribed under the FIEA must be reported to the relevant securities exchange.

(iii) Other wrongful acts

The following acts, which are considered wrongful, are generally prohibited:

- the use of wrongful means, schemes or techniques;
- misrepresentation of important matters, or omissions of material matters, the disclosure of which is necessary for the avoidance of misunderstanding;
- the use of false quotations;
- the spreading of rumours;
- fraudulent practices;
- commission of assault or intimidation; and
- market manipulation.

Investment in funds

Banks are not prohibited from investing in funds.

Arm's length rule

A bank is prohibited from entering into certain transactions with related persons (such as the bank's subsidiaries and affiliates) or the customers of such related persons. Specifically, a bank is prohibited from entering into:

- a transaction with a related person that is less beneficial to the bank compared to the benefits that the bank would obtain if it had entered into a transaction under the same conditions (in terms of transaction type and amount), with a person similar to the related person (but does not fall within the definition of a related person) in type, size, and creditworthiness;
- a transaction with a related person's customer that is less beneficial to the bank compared to the benefits that the bank would obtain if it had entered into a transaction under the same conditions (in terms of transaction type and amount), with a person similar to the related person's customer (but does not fall within the definition of a related person's customer) in type, size, and creditworthiness (in exchange for the execution of the contract between the related person and the related person's customer);
- a transaction with a related person under terms that are unjustly disadvantageous to the bank in light of the typical terms of similar transactions entered into by the bank; or
- a transaction or act, in whatever name, that is intended to evade the prohibitions above.

Bank confidentiality

Duty of confidentiality

There is no substantive law that imposes any duty of confidentiality on banks with respect to customer information in Japan. However, the Supreme Court of Japan has affirmed, based on commercial practice or contract, that financial institutions owe a duty of confidentiality to their customers with respect to customer information (such as information on customers' transactions and creditworthiness) that is obtained in connection with transactions with their customers.

A bank's duty of confidentiality is generally considered to be a duty that prohibits a bank from disclosing information obtained from its customers in connection with transactions with such customers without justifiable reasons. In other words, if there are "justifiable reasons", the bank may be exempt from the duty of confidentiality. There are no clear rules on exemptions to a bank's duty of confidentiality. However, the general view is that a bank will be exempt from the duty of confidentiality where: (a) a customer consents to the bank's disclosure of the customer' information; (b) disclosure of the customer information by the bank is required under the law; and (c) disclosure of the customer information is necessary for the bank to protect its rights and interests.

From a regulatory perspective, the Banking Act requires a bank to appropriately handle customer information acquired in relation to its business. More specifically, the Guidelines require every officer and employee of a bank to be well-informed about the bank's standards in the handling of customer information, its review system for the appropriate management of customer information, and its reporting system when customer information has been inadvertently leaked. These regulations are based on the understanding that a bank owes a duty of confidentiality to its customers under civil law and require banks to establish appropriate internal management systems to handle customer information from a regulatory perspective. Accordingly, it is necessary for a bank to carefully consider whether the disclosure of customer information is appropriate given its duty of confidentiality under civil law even when such disclosure is permissible under the relevant regulations.

Personal information

If customer information falls within the definition of Personal Information under the Act on the Protection of Personal Information (Act No. 57 of 2003, as amended) (**PIPA**), a bank needs to comply with the rules therein on appropriate handling of personal information to protect personal information. The purpose of the PIPA is to establish a basic principle for the fair handling of personal information, to prescribe the basic governmental policy considerations for protecting personal information, to make clear the obligations of national and local authorities, and to impose obligations that business operators which handle personal information are required to comply with. The purpose and scope of the general duty of confidentiality referred to above, and the provisions of the PIPA are not the same, but overlap to some extent. Accordingly, a bank which complies with the provisions of the PIPA also needs to carefully consider whether it can disclose customer information given its general duty of confidentiality under civil law.

There are no restrictions under Japanese law on the international transfer of Personal Information.

Alternative dispute resolution (**ADR**)

Banks are required to enter into an agreement with the Japanese Bankers Association for dispute resolution with respect to Banking Businesses. This financial ADR system is intended to provide banks' customers with an easier and faster way of resolving claims as compared to filing lawsuits against banks.

Deposit insurance system

The deposit insurance system in Japan protects depositors and other parties against the insolvency of banks in Japan. The Deposit Insurance Act (Act No. 34 of 1971, as amended; the **DIA**) governs the deposit insurance system. The Deposit Insurance Corporation of Japan (**DICJ**), which was established pursuant to the DIA, provides a public safety net to protect depositors. The deposit insurance system covers banks whose headquarters are located in Japan. Insured banks pay insurance premiums to the DICJ on an annual basis.

There are certain limitations to the coverage. For example, while ordinary deposits are covered under the deposit insurance system, foreign currency deposits and derivative deposits are not covered. Furthermore, while deposit accounts for settlement purposes will generally receive full coverage, other insured deposit accounts are generally covered by up to JPY 10 million per person and per bank.

Anti-money laundering

Verification upon Transaction

The Act on Prevention of Transfer of Criminal Proceeds (Act No. 22 of 2007, as amended (**APTCP**)) requires a bank to adequately perform verification of the identity of its customer

upon commencement of the specified transaction (such as acceptance of deposits, lending of funds, transactions under which a customer acquires securities and derivative transactions) (**Verification upon Transaction**).

In performing Verification upon Transaction, a bank is required, at the time of the transaction, to verify the following matters with respect to its customers and the customer's personnel who are in charge of the transaction:

- name;
- domicile (or location of principal office);
- date of birth (or date of birth of the representative);
- purpose of the transaction;
- occupation (or description of business); and
- identification of every shareholder of the customer which holds more than 25% of the voting rights in the customer.

The Verification upon Transaction must be conducted through the use of prescribed official identification documents (such as a registration certificate, an insurance certificate, a driver's licence, or a resident card).

Report of suspicious transactions

The APTCP requires a bank to report suspicious transactions to the FSA if any property accepted from its customer in connection with the bank's business is suspected to be criminal proceeds, or if the customer is suspected to have committed the crime of concealment of criminal proceeds or drug-related criminal proceeds.

The matters required to be reported to the FSA include:

- information on the bank filing the report (such as name, address and telephone number);
- information regarding the suspicious customer (such as the name, address, telephone number, nationality and the date of establishment); and
- the reason for the report.

Cross-border activities

Banking businesses

Foreign banks may not, in principle, enter into Banking Businesses in Japan or with persons in Japan without establishing a branch in Japan and obtaining a banking licence for a foreign bank branch.

Under the "foreign bank agency business" framework, 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 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 bank or foreign bank branch to obtain separate approval from the FSA.

Following the recent amendments, the capital ties requirement between the agent or intermediary bank in Japan and the foreign bank no longer applies, as long as the solicitation activities of the bank in Japan are conducted outside Japan.

Securities-related services

Foreign banks are, in principle, required to be registered pursuant to the FIEA to provide securities-related services (including dealing in public offerings or secondary distributions, dealing in private placements, or underwriting) in Japan or with persons in Japan.

Notwithstanding the above, foreign banks providing securities-related services in a foreign jurisdiction may provide the following services:

- securities-related services, including solicitation of securities, to a registered financial instruments business operator under the FIEA (**Financial Instruments Business Operator**) operating securities-related services;
- securities-related services from outside of Japan to financial institutions (only for their investment purposes or for the account of settlor under a trust agreement) and investment management companies (only for their investment management);
- sale and purchase of already-issued securities to or from banks upon request from customers of such banks for account of such bank;
- sale and purchase and intermediary, brokerage or agency services for sale and purchase of already-issued securities from outside of Japan with a person in Japan upon order from such person on condition that the offshore entity does not engage in any solicitation;
- sale and purchase of already-issued securities with a person in Japan via agency and intermediary by the relevant Financial Instruments Business Operator;
- negotiation with an issuer or a holder of the securities in Japan to determine the terms and conditions of a wholesale underwriting agreement with respect to public offerings, private placements or secondary distributions of such securities only when such public offering, private placement or secondary distribution is to be conducted outside Japan subject to notification to the Commissioner of the FSA as it involves a party in Japan; and
- participation in a wholesale underwriting agreement (an underwriter syndicate) in Japan if it meets the following requirements: (a) a foreign bank has a history of underwriting securities outside Japan for three years or more; (b) the foreign bank has a total capital and net assets of JPY 500 million or more; (c) a wholesale underwriter (and not the foreign bank) will negotiate with an issuer or a holder of the securities in Japan; (d) marketing of securities to be issued must be made outside of Japan; and (e) the foreign bank must obtain the approval of the Commissioner of the FSA.

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Mr. Miyamoto has also authored the following academic articles:

- "Investment funds in Japan: regulatory overview" (Practical Law – A Thomson Reuters Legal Solution, February 2016).
- The Japan chapter in "Neate and Godfrey: Bank Confidentiality 6th Edition" (Bloomsbury Professional, January 2015).

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