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Recent Amendments to the Regulations Applicable to Banks in Japan

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BIO

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He has considerable experience advising on all aspects of financial regulatory issues, including banking, securities and insurance regulations matters.

He has also served on secondment in the supervisory department of the FSA, where he had regulatory oversight of various financial institutions, such as major and regional banks, foreign banks, securities companies and fintech companies.

Recent Amendments to the Regulations Applicable to Banks in Japan

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On March 5, 2021, a bill (the "**Bill**") was submitted to the Diet based on the recommendations of the Financial System Council (the "**Council**") of the Financial Services Agency of Japan (the "**FSA**"). The Bill encompasses amendments to the Banking Act, the Act on Special Measures for Strengthening Financial Functions (the "**Special Measures Act**"), and the Financial Instruments and Exchange Act (the "**FIEA**"), to strengthen and enhance the stability of Japan's financial system in response to the socio-economic impact of Covid-19 and other developments. The Bill was approved by the Diet on May 19, 2021.

> "Under the Banking Act, banks are only permitted to engage in core banking activities and certain other activities.

Based on the recommendations of the Council, the FSA is also amending the Cabinet Office Ordinance on Financial Instruments Business (the "**COOFIB**") and the supervisory guidelines in relation to firewall regulations.

This article provides an outline of the following: (i) the amendments to the Banking Act, which have come into force, (ii) the amendments to the Special Measures Act, which have come into force and (iii) the amendments to the COOFIB and the relevant supervisory guidelines published by the FSA, part of which have also come into force.

1. AMENDMENTS TO THE BANKING ACT

Given the headwinds presented by the aging population and Covid-19 in Japan, banks are expected to stand at the frontline of efforts to rehabilitate the economy and spearhead sustainable growth. In line with this, the Council's "Banking System Working Group" undertook a review of the banking system and published a report on December 22, 2020 summarising its recommendations of the measures that can be taken to improve the banking system (the "**Banking System Report**"). The improvement measures are aimed at, among others, relaxing the scope of businesses in which banks and their subsidiaries may engage, based on recent socio-economic developments. The Bill includes amendments to the Banking Act based on the Banking System Report.

Under the Banking Act, banks are only permitted to engage in core banking activities (i.e., deposit taking, lending and funds remittance), limited businesses ancillary to banking activities, and certain securities-related businesses specified in the Banking Act. Banks are also generally prohibited from holding subsidiaries or holding more than 5% of the voting rights in domestic companies ("**Restricted Entities**") that engage in businesses other than those permitted under the Banking Act, except in certain limited circumstances.

Following amendments to the Banking Act under the Bill (the "**Banking Act Amendments**"), banks are permitted to engage in certain businesses relating to the digitalisation and rehabilitation of regional economies in Japan by utilising their banking-related management resources. Under the Banking Act Amendments, such businesses, which are considered ancillary to banking activities, include provision of the following services: (i) services that support the livelihood of customers; (ii) IT systems and applications originally developed by banks for internal use; (iii) data analysis, marketing and advertising services; (iv) temporary staffing services; and (v) consulting and business-matching services.

Under the Banking Act Amendments, banks are also able to more flexibly invest in domestic companies. For example, a bank may hold a subsidiary that engages in a business related to the rehabilitation of regional economies in Japan. The scope of domestic companies in which a bank may invest has been expanded in relation to venture investments and business rehabilitation projects. Such investments may be conducted through the subsidiaries of banks that are established for purposes of investing in other companies. Further, the requirements for investments in such companies have been relaxed and the permissible term for which a bank may invest in such companies has been extended to enable banks to make broader and longer term commitments to venture investments, business rehabilitation and business succession projects.

Under the erstwhile banking regulations, banks and banking groups were permitted, with the FSA's approval ("**Investment Approval**"), to hold more than 5% of voting rights in Restricted Entities if (i) the business of the Restricted Entity would or would potentially enhance the operational sophistication of the banks or (ii) the business of the investee company would enhance or would potentially enhance the convenience of customers of the relevant bank ("**Complementing Companies**"). This has enabled Japanese banks to obtain Investment Approvals for investments in fintech companies, such as those that have developed electronic Know Your Customer (e-KYC) or fraud detection technologies, as well as regional trading companies. The Banking Act Amendments augments this by including provisions that expand the scope of situations in which banks and banking groups may apply for Investment Approvals (including allowing investments in companies that would contribute or would potentially contribute to social sustainability), and relaxing the criteria for Investment Approval in certain circumstances. Further, banking groups certified as having sufficient financial strength and satisfactory levels of corporate governance may invest in Complementing Companies without Investment Approval. Accordingly, the Banking Act Amendments enable banks and banking groups to expand the scope of their businesses based largely on their resourcefulness and ingenuity.

The Banking Act Amendments are also designed to strengthen the international competitiveness of Japanese banks. Under the provisions before the Banking Act Amendments, banks and bank holding companies that hold foreign banks as subsidiaries are generally required to dispose of their subsidiaries within five years of acquisition if the businesses of such subsidiaries fall outside the scope of the permissible businesses under the Banking Act. A bank or bank holding company that fails to do so would be required to restructure the business of its foreign bank subsidiary(ies) for compliance with the Banking Act or to liquidate the foreign bank subsidiary(ies). Under the Banking Act amendments, however, the timeframe for the mandatory sell-off has been extended to ten years, with the possibility of a further extension if regulatory approval is obtained. Such extension may be obtained if it can be shown that the extension is necessary for the competitiveness of the foreign bank's subsidiaries. The Banking Act Amendments also allow banks and bank holding companies to invest directly in foreign money lenders and lease companies that concurrently engage in non-"finance-related" businesses, as long as the main businesses of such money lenders and lease companies are money lending, leasing or other finance-related businesses.

Drafts of the cabinet order and cabinet office ordinances for the Bill were released for public consultation for a period of one month on August 6, 2021. A draft of the guidelines containing details of the Banking Act Amendments was also released for public consultation for a period of one month on August 27, 2021. The results of the public consultation were published on November 10, 2021, and the Banking Act Amendments came into force on November 22, 2021.

2. Amendments to the Special Measures Act

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> The Banking Act Amendments are also designed to strengthen the international competitiveness of Japanese banks.

As noted above, the Bill also includes amendments to the Special Measures Act (the "**Special Measures Act Amendments**"). The Special Measures Act Amendments established a grant system to encourage regional banks to pursue mergers or integrations with other regional banks (the "**Grant System**"). Due to concerns about the business viability of some regional banks in Japan as a result of greying demographics, low interest rates, and other factors, the Grant System seeks to encourage mergers or integration of those regional banks to enable them to remain going concerns. The Grant System allows regional banks to apply for grants from the Deposit Insurance Corporation of Japan (the "**DICJ**") to defray part of the initial transition costs it will incur in such mergers or integrations. To apply, a regional bank has to submit a post-merger or post-integration business plan to the FSA by the end of March 2026. The FSA will review the business plan to consider whether it meets certain criteria, including (i) whether the financial services provided by the relevant banks are essential to the economy of the applicable region, (ii) whether the continued provision of financial services by the relevant banks is sustainable economically and

(iii) whether the business plan, if implemented, will enable the relevant banks to continue with their provision of financial services. A grant will be provided if the business plan is approved by the FSA. Grants will be made from deposits with the DICJ. Under the relevant guidelines of the DICJ, the maximum amount of a grant for a merger or integration is the lower of the (i) one-third of all expenses incurred for the merger or integration or (ii) JPY 3 billion. The Special Measures Act Amendments came into effect on July 21, 2021, and the FSA announced its first approval for a grant on September 28, 2021.

3. Amendments to Firewall Regulations

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> As a general rule, no non-public information regarding a client may be shared between a bank and a securities company without that client's prior written consent.

The current FIEA and the COOFIB contain a "*Ginsho* firewall regulation." (A *Ginsho* firewall refers to a firewall between banks and securities firms.) As a general rule, pursuant to such regulation, no non-public information regarding a client may be shared between a bank and a securities company within the same financial group without that client's prior written consent.

Following discussions at the Council's "Working Group on Capital Market Regulations", the Council published its first capital market report ("**First Capital Market Report**") on December 23, 2020, followed by a second capital market report ("**Second Capital Market Report**") on June 18, 2021.

The First Capital Market Report addresses, among other issues, amendments to the firewall regulations between banks and securities firms in respect of foreign corporate clients. Amendments to the COOFIB to exclude information relating to foreign corporate clients from the definition of non-public information were proposed, and subsequently published for public consultation on March 26, 2021. This was followed by eventual amendments to the COOFIB, which came into force on June 30, 2021.

The Second Capital Market Report address, among other issues, amendments to the firewall regulations between banks and securities firms in respect of domestic clients. Amendments to the COOFIB and to the supervisory guidelines, reflecting the recommendations in the Second Capital Market Report, were published for public consultation on December 24, 2021.

(i) Foreign Corporate Client Information Firewall

As mentioned above, as a general rule, pursuant to the firewall regulations, no non-public information regarding a client may be shared between a bank and a securities company within the same financial group without that client's prior written consent. Such general rule was applicable to foreign corporate clients unless certain exemptions apply (such as the opt-out rule or where consent by email is provided by the client).

According to the First Capital Market Report, however, non-public information relating to foreign corporate clients should be excluded from the scope of the *Ginsho* firewall regulation. Accordingly, as mentioned above, amendments to the COOFIB to exclude information relating to foreign corporate clients from the definition of non-public information were proposed, and subsequently published for public consultation on March 26, 2021. This was followed by eventual amendments to the COOFIB, which came into force on June 30, 2021.

(ii) Domestic Client Information Firewall

Pursuant to the discussions at the Council's "Working Group on Capital Market Regulations" following publication of the First Capital Market Report, a Second Capital Market Report was published on June 18, 2021. The Second Capital Market Report contains the Council's recommendations on amendments to COOFIB, including recommendations for amendments to be made to the *Ginsho* firewall regulation in respect of domestic clients. As noted above, the general rule under current regulations is that a domestic client's prior written consent is needed before non-public information regarding client can be shared between a bank and a securities company within the same financial group. However, the consent to sharing of non-public information relating to domestic corporate clients (i.e., excluding domestic clients who are individuals) is subject to an opt-out rule.

According to the Second Capital Market Report and the proposed amendments to the COOFIB, such firewall regulations for domestic clients will be relaxed to a certain extent. More specifically, for clients that belong to a corporate group that includes listed companies ("**Listed Company-Related Clients**"), prior written consent would not be necessary for the sharing of non-public information regarding that client between a banking entity and a securities company within the same corporate group, unless the client specifically opts out of such information-sharing.

Further, the procedures for opt-in will be simplified for both the domestic corporate clients as well as the domestic individual clients under the proposed amendments to the COOFIB, based on the Second Capital Market Report. For example, the proposed amendments to the COOFIB, which are based on the Second Capital Market Report, include electronic media (such as email) as acceptable media through which clients may indicate their agreement to opt into information-sharing. There are certain other measures implemented in the proposed amendments to the COOFIB based on the Second Capital Market Report. Among these is the relaxation of the limitations on access to non-public information by those who double-hat as officers and/or employees of both a bank and the securities company within the banking group. Under such measures, information-sharing between banks and securities companies within a banking group will be relaxed.

In exchange for such relaxation of the regulations on information-sharing, regulations on strengthening the effectiveness of prevention of harmful effects of information-sharing between banks and securities companies will be enhanced. According to the Second Capital Market Report, the proposed amendments to the COOFIB, as well as the supervisory guidelines, the regulations to be enhanced will include those relating to (i) management of the customer information by banks (e.g., prohibition against the sale and purchase of securities by banks and their employees based on undisclosed material information in respect of listed companies), (ii) management of conflict of interests among the banking groups (which will enhance the effectiveness of management of conflict of interests by a banking group) and (iii) prevention of abuse of dominant bargaining position by banks (e.g., enhancing the regulatory supervision of such abusive actions in coordination with the Japan Fair Trade Commission).

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The eventual amendments to the COOFIB, after the public consultation period, will come into force in due course.

As mentioned above, amendments to the COOFIB as well as the supervisory guidelines reflecting the recommendations in the Second Capital Market Report, were published for public consultation on December 24, 2021. The eventual amendments to the COOFIB, after the public consultation period, will come into force in due course.