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CHAMBERS GLOBAL PRACTICE GUIDES

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# Banking Regulation 2023

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**Japan: Law & Practice**

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## Law and Practice

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## 1. Legislative Framework

### 1.1 Key Laws and Regulations

#### Principal Laws and Regulations

##### *The Banking Act*

The principal laws and regulations governing the banking sector are the Banking Act (Act No 59 of 1981) and the subordinate regulations enacted thereunder, including the Order for Enforcement of the Banking Act (Cabinet Order No 40 of 1982) and the Regulation for Enforcement of the Banking Act (Ministry of Finance Order No 10 of 1982).

The Banking Act defines banking as the business of conducting both the acceptance of deposits and the lending of funds, or providing fund transfer services. Any person wishing to engage in banking must obtain a licence and will be subject to regulations under the Banking Act, including:

- restrictions on the scope of business by banks;
- restrictions on the scope of business by banks' subsidiaries;
- a code of conduct;
- governance requirements;
- capital adequacy requirements;
- accounting (including disclosure) requirements;
- regulations on major shareholders of banks; and
- regulations on bank holding companies.

The purpose of these regulations under the Banking Act is to “preserve the credibility of banking services in view of their public nature; to achieve the sound and appropriate management of banking services in order to ensure protection for depositors and facilitate the smooth functioning of financial services; and to thereby contrib-

ute to the sound development of the national economy” (Article 1 of the Banking Act).

In addition to licensed banks, there are also other types of deposit-taking financial institutions in Japan, such as credit associations, credit co-operatives, labour banks and agricultural co-operatives, which are regulated under a separate law.

##### *The Financial Instruments and Exchange Act*

Contrary to “universal banks” in Europe, banks in Japan are generally prohibited from engaging in securities business, but this prohibition has gradually been relaxed, and the scope of securities business that banks are allowed to conduct has gradually been expanded. Banks can also conduct certain securities business through their subsidiaries. Securities business (whether conducted by banks themselves or through their subsidiaries or Bank Holding Company subsidiaries) is regulated by the Financial Instruments and Exchange Act (Act No 25 of 1948).

A recent amendment to the Act on Sales, etc, of Financial Instruments established a new regulatory framework for “Financial Service Brokerage” in order to facilitate a one-stop service by brokers to offer financial products across all sectors of banking, insurance and securities. With respect to securities business, subsidiaries of banks and Bank Holding Companies may register as “Financial Service Brokers” and engage in a certain limited scope of securities business.

#### Regulators

##### *Financial Services Agency*

The principal regulator of the banking sector is the Financial Services Agency (FSA), which is authorised under the Banking Act to supervise banks. The authority of the FSA includes:



- conducting on-site inspections and off-site monitoring;
- issuing reporting orders, business improvement orders or business suspension orders; and
- revoking banking licences.

The FSA issues supervisory guidelines on the interpretation of laws and regulations. Historically, the FSA also issued an inspection manual to be used as a checklist in its on-site inspections, but this manual was abolished in 2019 in an effort to transform the FSA's supervisory approaches into more substantive, forward-looking and holistic analysis and judgement. The FSA has instead issued certain principles, theme-specific reports to announce its supervisory policies and several types of area-specific guidance.

The FSA also has authority under the Financial Instruments and Exchange Act to supervise securities business conducted by banks or their subsidiaries. A portion of the FSA's authority to conduct inspections of securities business is delegated to the Securities and Exchange Surveillance Commission.

### *Bank of Japan*

The Bank of Japan (BOJ) is the central bank of Japan. It does not have regulatory authority under the Banking Act, but it has a right to conduct on-site examinations of banks under the agreements that it enters into with the banks when opening accounts for such banks.

## 2. Authorisation

### 2.1 Licences and Application Process Banking Licences

The Banking Act defines banking as the business of conducting both the acceptance of deposits (including instalment savings) and the lending of funds (including discounting of bills and notes), or providing fund transfer services. Any person wishing to engage in banking must obtain a licence under the Banking Act.

If a person wishes to conduct only the lending of funds and not the acceptance of deposits, registration as a money lending business under the Money Lending Business Act would suffice. The lending of funds requires a banking licence only when it is conducted together with the acceptance of deposits.

If a person wishes to provide only fund transfer services, a registration of such services under the Payment Services Act (PSA) would also suffice. It should be noted, however, that the PSA requires the regulator's approval in addition to a registration of fund transfer services when a person wishes to provide fund transfer services exceeding JPY1 million per transfer.

Fund transfer service providers are expected to play more important roles in the payment and settlement system. As explained in **10.1 Regulatory Developments** (Broaden Membership Base of Interbank Payment System), a recent amendment of the rules of the interbank payment system means that fund transfer service providers are now permitted to participate in the system. Along with other initiatives, this change is expected to contribute to more efficient payment and settlement systems, and to the movement towards a cashless society in Japan.

The digitisation of financial services also affects the regulatory framework. As explained in **10.1 Regulatory Developments** (New Regulatory Framework for Stablecoins), while the issuance of fiat-backed stablecoins is already regulated, there had been no holistic regulatory framework for the intermediaries of such stablecoins. A recent amendment introduces a new framework mainly for regulating such intermediaries.

### Restrictions on Licensed Banks' Activities

The Banking Act provides for restrictions on the business scope of licensed banks. In particular, banks are not allowed to conduct any business other than banking, business incidental to banking, and certain business specifically permitted under the Banking Act or other laws.

The scope of incidental business has been expanded to explicitly include:

- management consulting;
- customer referral;
- information provision and advice business;
- worker dispatching business;
- the business of developing, selling and maintaining IT systems and programmes;
- the provision of advertisements, survey and data analysis services; and
- the provision of care services by way of making cyclic visits to customers.

The Banking Act also provides for restrictions on the business scope of subsidiaries of licensed banks, although these restrictions are not as strict as those applicable to the banks themselves. Recent amendments have allowed banks and Bank Holding Companies to own a company that “provides services that contribute to or are expected to contribute to increased sophistication in the banking conducted by the bank or to enhanced convenience for bank users, through

the use of information and telecommunications technology or other technologies” (Sophistication Service Company), subject to prior approval from the regulator, or subject to prior notification only where certain conditions are met, such as capital and governance requirements.

### Requirements for a Banking Licence

#### *Criteria for examination*

The Banking Act requires the regulator to examine whether an applicant for a banking licence satisfies the following criteria:

- “the applicant has a sufficient financial basis to perform banking services soundly and efficiently, and has good prospects in relation to income and expenditure in connection with those services”; and
- “in light of such points as its personnel structure, the applicant has the knowledge and experience to perform banking services appropriately, fairly, and efficiently, and has sufficient social credibility” (Article 4, Paragraph 2 of the Banking Act).

In addition, the regulator is authorised to impose such conditions on a banking licence as it deems necessary in light of the above criteria.

#### *Statutory requirements under the Banking Act*

A bank must be a stock company incorporated under the Companies Act of Japan and must have:

- a board of directors;
- a board of company auditors, audit and supervisory committee or nominating committee, etc; and
- a financial auditor.

The Banking Act stipulates fit and proper principles requiring certain directors and officers of a bank to have certain knowledge and experience, as well as sufficient social credibility. The stated capital of a bank must be no less than JPY2 billion.

If an applicant for a banking licence is a foreign bank, it does not need to be a stock company incorporated under the Companies Act of Japan, but it is required to establish a branch in Japan. The fit and proper principles explained above will apply to the representative in Japan of such foreign bank. A foreign bank branch is required to keep assets corresponding to its stated capital within Japan in an amount of no less than JPY2 billion.

## Application Process

The application process usually consists of the following steps with the FSA:

- preliminary consultation; and
- formal application.

In the first step, the applicant consults with the FSA and provides such information as is informally requested by the FSA for its preliminary examination. After completing this informal communication with the FSA, the applicant proceeds to the second step and submits the application documents together with supporting materials to the FSA.

The Banking Act provides for a standard processing period for the second step. In particular, the regulator must endeavour to process the application within one month from receipt thereof. On the other hand, there is no standard processing period for the first step, as it is not a formal process under the Banking Act. The length of time required for the first step is highly

dependent on the circumstances surrounding the individual applicants.

An applicant for a banking licence must pay JPY150,000 as a registration and licence tax for each application. This is the only statutory cost incurred in obtaining a banking licence. In practice, it is usual for an applicant to retain advisers to assist in the application process, and for the applicant to incur fees in relation to such advisers.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank Notification of Large Volume Holding

A person who acquires more than 5% of the total voting rights in a bank must submit a notification to the regulator as required under the Banking Act. If the notified percentage of the voting rights increases or decreases by 1% or more, or if there is a change in the information stated in the notification, such person must submit a report on such change to the regulator.

### Bank Major Shareholder

A person must obtain prior approval from the regulator to acquire 20% (or, as the case may be, 15%) or more of the total voting rights in a bank. Once approved, such person is called a “Bank Major Shareholder” under the Banking Act and will be subject to the supervision of the regulator. In particular, if the holding ratio of a Bank Major Shareholder exceeds 50%, the regulator has the authority to order the Bank Major Shareholder to submit an improvement plan to ensure sound management of the bank when necessary.

## Bank Holding Company

A Bank Holding Company is defined as a holding company that has a bank as its subsidiary. A subsidiary is defined as a company the majority of whose voting rights (ie, more than 50%) are held by another company. A person must obtain prior approval from the regulator to become a Bank Holding Company.

If a person wishes to acquire more than 50% of the total voting rights in a bank, there is an issue of whether such person must obtain approval as a Bank Holding Company or a Bank Major Shareholder. Approval as a Bank Holding Company will be required only if such person falls under the definition of a holding company – ie, a company the majority of whose assets (ie, more than 50%) are comprised of shares in its subsidiaries in Japan.

A Bank Holding Company is subject to broader and stricter regulations than those applicable to a Bank Major Shareholder. The regulations applicable to a Bank Holding Company include:

- restrictions on the permitted scope of business;
- restrictions on the scope of subsidiaries that a Bank Holding Company is permitted to own;
- governance requirements;
- capital adequacy requirements;
- accounting (including disclosure) requirements; and
- supervision by the regulator (including authority to order a Bank Holding Company to submit an improvement plan to ensure sound management of the bank when necessary).

## Foreign Shareholdings

There is no restriction on foreign shareholdings under the Banking Act. The above regulations

on shareholdings in a bank (ie, notification of large volume holding, Bank Major Shareholder regulations, Bank Holding Company regulations) apply regardless of whether the shareholder is a domestic or foreign person. It should be noted, however, that the acquisition of a Japanese entity by a foreign investor may be subject to notification or other requirements under the Foreign Exchange and Foreign Trade Act.

## 4. Supervision

### 4.1 Corporate Governance Requirements

Under the Banking Act (Article 4-2), a bank must be a stock company (*kabushiki-kaisha*) as set forth in the Companies Act, with the following organs:

- a board of directors;
- a board of company auditors, a supervisory committee or a nominating committee, etc, as defined in Article 2, Paragraph 12 of the Companies Act; and
- a financial auditor.

A foreign bank that has a branch office in Japan is not subject to this organisational requirement (Article 47, Paragraph 2 of the Banking Act).

In addition, III-1 of the “Comprehensive Guidelines for Supervision of Major Banks, etc” issued by the FSA lists supervisory viewpoints to which the FSA would pay attention with respect to the corporate governance of a bank.

For example:

- as a general principle, corporate governance is important for the stability of the financial system, and for the sustainability and appropriate management of a bank;

- a listed bank or a listed Bank Holding Company should comply with “Japan’s Corporate Governance Code – Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term”, issued by the Tokyo Stock Exchange, Inc;
- a listed bank or a listed Bank Holding Company should appoint at least two independent outside directors who would contribute to sustainable corporate growth and the increase of corporate value; and
- a listed bank or a listed Bank Holding Company should disclose its policy with respect to cross-shareholdings.

## 4.2 Registration and Oversight of Senior Management

### Process of Electing Directors and Executive Officers

As a general rule not limited to a bank, a director of a stock company (*kabushiki-kaisha*) under the Companies Act is elected by a resolution at a shareholders’ meeting (Article 329 of the Companies Act), while an executive officer of a company with a nominating committee, etc (as defined in Article 2, Paragraph 12 of the Companies Act), is elected by a resolution at a meeting of the board of directors. Neither the Companies Act nor the Banking Act stipulate a regulatory approval requirement in respect of the appointment of a director or an executive officer.

### Restriction on Directors and Executive Officers Concurrently Holding Other Positions

A director (or an executive officer, if the bank is a company with a nominating committee, etc, as defined in Article 2, Paragraph 12 of the Companies Act) who is engaged in the day-to-day business operations of a bank must not engage in the day-to-day business operations of any other company without the authorisation of the Prime

Minister (Article 7, Paragraph 1 of the Banking Act).

When an application is filed for such authorisation, the Prime Minister must not grant that authorisation unless the Prime Minister finds that the particulars to which the application pertains are unlikely to interfere with the sound and appropriate management of bank services (Article 7, Paragraph 2 of the Banking Act).

A foreign bank that has a branch office in Japan is subject to these rules (Article 47, Paragraph 2 of the Banking Act).

### Eligibility for Director or Executive Officer

A director engaged in the day-to-day business of a bank (or an executive officer engaged in the day-to-day business of a bank, if the bank is a company with nominating committee, etc, as defined in Article 2, Paragraph 12 of the Companies Act) must have the knowledge and experience to be able to carry out the business management of a bank appropriately, fairly and efficiently (Article 7-2, Paragraph 1 of the Banking Act).

In addition, no person subject to an order of commencement of bankruptcy proceedings who has not been discharged from bankruptcy and no person who is treated as the equivalent of the foregoing under foreign laws and regulations may become a director or an executive officer of a bank (Article 7-2, Paragraph 2 of the Banking Act).

A foreign bank that has a branch office in Japan is subject to these rules (Article 47, Paragraph 2 of the Banking Act).



## Notification

A bank must file a prior notification with the Prime Minister when a director representing the bank or a director engaging in the ordinary business of the bank is appointed or resigns (Article 53, Paragraph 1, Item 8 of the Banking Act and Article 35, Paragraph 1, Item 3 of the Regulation for Enforcement of the Banking Act).

A foreign bank that has a branch office in Japan is subject to these rules (Article 47, Paragraph 2 of the Banking Act).

## Duties of Directors and Executive Officers

As a general rule under the Companies Act, directors and executive officers owe a duty of care and a duty of loyalty to the company (Article 330, Article 355 and Article 402, Paragraph 2 of the Companies Act, and Article 644 of the Civil Code).

A bank must not extend credit to its directors or executive officers under terms and conditions that are disadvantageous to the bank compared to the ordinary terms and conditions under which the bank extends credit (Article 14, Paragraph 1 of the Banking Act).

## 4.3 Remuneration Requirements

The Banking Act provides no rule with respect to remuneration paid by a bank to its directors, executive officers or employees.

III-2-3-5 of the “Comprehensive Guidelines for Supervision of Major Banks, etc” issued by the FSA lists supervisory viewpoints to which the FSA would pay attention with respect to remuneration paid by a bank to its directors, executive officers or employees, as follows:

- a bank’s remuneration system is not appropriate if it drives excessive risk-taking by a

director, an executive officer or an employee of the bank;

- the remuneration committee of a bank should supervise the bank’s remuneration system to ensure that it is appropriately established and managed;
- the remuneration committee of a bank should check whether or not the amount of remuneration would have a material effect on the bank’s core capital;
- the remuneration committee of a bank should communicate with the risk monitoring department of the bank;
- the remuneration committee of a bank should check whether or not its remuneration system causes excessive short-termism or becomes excessively performance-based; and
- the remuneration of staff in the risk monitoring department and compliance department should be determined independently from other business departments and based on the importance of their roles.

In cases where the FSA thinks that a bank’s remuneration system is problematic as a result of regular off-site monitoring or inspection, it shall require the bank to submit a report under Article 24, Paragraph 1 of the Banking Act as necessary. If a serious problem is recognised, the FSA shall take administrative action, such as issuing an order for business improvement under Article 26 of the Banking Act.

## 5. AML/KYC

### 5.1 AML and CFT Requirements

#### Overview

The principal laws and regulations governing anti-money laundering and counter-terrorist financing are the Act on Prevention of Transfer of Criminal Proceeds (Act No 22 of 2007) and

the subordinate regulations enacted thereunder, including the Order for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds (Cabinet Order No 20 of 2008) and the Regulation for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds (Ministry of Finance Order No 1 of 2008).

In addition, the FSA issues “Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism”, which clarify the required actions and expected actions to be implemented by financial institutions, such as banks, and how the FSA shall conduct monitoring going forward.

The Act on Prevention of Transfer of Criminal Proceeds provides for preventative measures in combating money laundering and terrorist financing, by imposing obligations such as customer due diligence, record-keeping and the reporting of suspicious transactions on “specified business operators”. A bank is one such “specified business operator”.

As explained in **10.1 Regulatory Developments** (Development of Sharing of AML/CFT Systems and Services), a recent amendment aims to develop the sharing of AML/CFT systems and services among financial institutions. The banking industry is preparing for the establishment of a new framework for sophisticated AML/CFT operations under the amended regulations.

### **Customer Due Diligence (Article 4 of the Act on Prevention of Transfer of Criminal Proceeds)**

When a bank enters into a transaction (“Specified Transaction”) listed in Article 7 of the Order for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds (Cabinet Order No 20 of 2008) with its customers who are natural persons, it is required to verify the following by

checking their identification documents, such as a driver’s licence:

- the customer’s identification data (name, address and date of birth);
- the purpose and intended nature of the transaction; and
- the customer’s occupation.

When a bank enters into a Specified Transaction with its customers who are legal persons, such as corporations, it must verify their identification data (the name and location of the head office or main office), the purpose and intended nature of the transaction, the type of business, and the beneficial owner(s).

When a bank enters into a Specified Transaction with an agent or a representative of a customer, it must verify the identification data in respect of such agent or representative.

When a bank enters into a transaction that has a high risk of being related to money laundering or terrorist financing, such as a transaction where the bank suspects its counterparty is disguising its identity, the bank is required to verify items related to identification at the time of the transaction, using a more robust method.

### **Record-Keeping**

A bank is required to prepare and preserve verification records collected at the time of the transaction, as well as measures taken for verification of the customer at the time of the transaction, for seven years from the day when the transaction is made or when an agreement related to the transaction is terminated, depending on the type of the transaction (Article 6 of the Act on Prevention of Transfer of Criminal Proceeds).

In addition, a bank is required to prepare records of the date and contents of transactions, and to keep these records for seven years from the date of such transaction (Article 7 of the Act on Prevention of Transfer of Criminal Proceeds).

## Reporting Suspicious Transactions (Article 8 of the Act on Prevention of Transfer of Criminal Proceeds)

A bank is required to file a suspicious transaction report with the competent administrative authority in cases where assets received through a transaction are suspected to be criminal proceeds, or where the customer is suspected to be engaged in money laundering.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime Scheme Administration and Supervision

The Deposit Insurance Corporation (DIC) is a special corporation organised under the Deposit Insurance Act of Japan (Act No 34 of 1971 – DIA) and administers the deposit insurance system. The Prime Minister generally supervises DIC's operation of the system, and also determines or approves specific administrative procedures in respect of failed financial institutions or successors thereto. The Prime Minister delegates most of his or her authorities under DIA to the FSA.

#### Scope of Protection

The deposit insurance system protects depositors by providing financial assistance to a successor financial institution and thereby indirectly making insurance proceeds available to depositors (Financial Assistance Method), or by directly paying insurance proceeds to depositors of a failed financial institution (Insurance Pay-out Method). The Financial Assistance Method is more cost-effective and causes less confusion

than the Insurance Pay-out Method. DIC has resorted to the Financial Assistance Method in dealing with almost all failed financial institutions.

Either way, only those with insured deposits with insured financial institutions are protected under the system up to the statutory limit (if applicable).

#### *Insured financial institutions*

Banks and other deposit-taking financial institutions licensed in Japan are insured under the deposit insurance system, with some exceptions.

One of the exceptions is foreign branches of licensed financial institutions. Another exception is Japanese branches of foreign banks: under the Banking Act, instead of establishing a licensed bank in Japan, foreign banks may obtain a licence and conduct banking business through their branches in Japan, but such licensed branches are not covered by the deposit insurance system. Agricultural/fishery co-operatives and related financial institutions are insured not under the deposit insurance system but under a separate “savings” insurance system.

Governmental financial institutions are not covered by these insurance systems. Insurance and securities firms receive premiums, margins and other types of funds from their customers, the economic nature of which funds is similar to deposits; however, these firms are not deposit-taking financial institutions and are thus not insured under the aforementioned insurance systems. Nonetheless, part of such customer funds is covered by separate customer protection systems. As described in **9.1 Legal and Regulatory Framework**, these firms are also subject to the new resolution regime established in line with the FSB Key Attributes.

## *Insured deposits*

Deposits for payment and settlement (Settlement Deposits) with insured financial institutions are fully covered by the deposit insurance system (ie, without being restricted by the statutory limit applicable to General Deposits – defined below). To qualify as Settlement Deposits, the deposits must bear no interest, be redeemable on demand, and be used for payment and settlement.

Deposits other than Settlement Deposits (General Deposits) are also protected but only within the statutory limit of JPY10 million in principal plus interest thereon, per depositor, per insured financial institution.

Certain deposits are disqualified as Settlement Deposits and General Deposits. For example, foreign currency deposits are disqualified, given the volatility of exchange rates. Negotiable certificates of deposit, bearer deposits and deposits under an alias or fictitious name are also disqualified due to difficulties in identifying the true depositors. Other examples of disqualified deposits are deposits from insured financial institutions and deposits in respect of Japan offshore market accounts.

In addition to Settlement Deposits and General Deposits, when an insured financial institution is processing a fund remittance or certain other settlement transactions requested by a customer, obligations in relation to the customer are also fully protected. If the settlement transactions are denominated in a foreign currency or requested by other insured financial institutions, the obligations thereunder are disqualified and not insured.

Uninsured deposits or obligations may be paid as tenders or dividends through bankruptcy/rehabilitation proceedings, depending on the

status of assets of the relevant failed financial institution (see **9.1 Legal and Regulatory Framework**).

## **Funding of Deposit Insurance System**

DIC is funded mainly by the receipt of insurance premiums from insured financial institutions and capital contributions from the government, BOJ and certain financial institutions. DIC also raises funds by issuing bonds or by borrowing from financial institutions.

## **7. Bank Secrecy**

### **7.1 Bank Secrecy Requirements**

#### **Duty of Confidentiality**

Neither the Banking Act nor any other act contains any provision in respect of bank secrecy requirements. In Japan, banks' duty of confidentiality has been established and developed by the case law of the Supreme Court, which has held that a financial institution owes its customers a duty of confidentiality based on business practices or an agreement between the financial institution and its customer; the financial institution may not disclose information on transactions between itself and its customer, information on a customer's credit risk, or any other customer information to another person, unless for good reason.

Based on such established case law, Article 12-2, Paragraph 2 of the Banking Act provides that a bank must appropriately handle customer information it acquires in the course of its services. In addition, III-3-3 of the "Comprehensive Guidelines for Supervision of Major Banks, etc" issued by the FSA states that the FSA would pay attention to whether or not a bank has established an appropriate information management system.



It is generally understood that a bank may disclose customer information upon reasonable grounds, such as when the customer explicitly or implicitly consents to such disclosure, or when the bank is legally required to disclose customer information. It should be noted that a bank is not always allowed to transfer its customer information to its affiliates under such duty of confidentiality. Because the bank's duty of confidentiality has been established and developed by case law, it is sometimes unclear whether or not a bank may disclose certain customer information without breaching its duty of confidentiality, including if a bank shares certain customer information with its affiliates.

When a bank breaches such duty of confidentiality, it would be liable for damage to the customer arising from such breach. In addition, if, as a result of regular offsite monitoring or inspection, the FSA thinks that a bank's information management system is problematic, it shall require the bank to submit a report under Article 24, Paragraph 1 of the Banking Act as necessary. If a serious problem is recognised, the FSA shall take administrative action, such as issuing an order for business improvement under Article 26 of the Banking Act.

## Personal Data Protection

If a bank's customer is a natural person, the customer information would fall under "personal data" under the Act on the Protection of Personal Information (Act No 57 of 2003), and the disclosure of such customer information would be subject to personal data protection regulations, including the Act on the Protection of Personal Information. A bank is required to prevent the leakage, loss or damage of customer information that falls under personal data, and to conform to the requirements regarding the scope and purpose of any shared use.

## Firewall Regulations

A bank is subject to the so-called firewall regulations that prohibit banks and securities firms sharing their non-public customer information (limited to certain material information, and excluding information of foreign corporate customers) with their affiliates without a customer's prior approval; however, the sharing of non-public customer information for internal management purposes is permitted, and the sharing of non-public corporate customer information is permitted if the relevant bank provides a corporate customer with an opt-out opportunity in advance.

As explained in **10.1 Regulatory Developments** (Amendment of Firewall Regulations), a recent amendment has optimised the firewall regulations.

## 8. Prudential Regime

### 8.1 Capital, Liquidity and Related Risk Control Requirements

#### Adherence to Basel III Standards for Internationally Active Banks

Under the Banking Act, banks must meet capital, liquidity and related risk control requirements. They are also required to avoid having large exposures to single counterparties. To enable group-level risk management, the Banking Act and regulations thereunder cover not only banks but also Bank Holding Companies.

This risk control framework aims to be consistent with the Basel III standards set by the Basel Committee on Banking Supervision (BCBS), to the extent applied to internationally active banks (ie, banks having a branch or a banking subsidiary overseas).

Reviews of this risk control framework under the BCBS's Regulatory Consistency Assessment Programme have assessed the framework as being "compliant" with the requirements of the Basel III standards that relate to risk-based capital, liquidity, global and domestic systemically important banks (G-SIBs and D-SIBs).

No results of assessments of other requirements, such as the stable funding ratio and large exposure framework, are currently available; however, the FSA has continuously amended the relevant regulations with a view to adhering to the updated Basel III standards in these areas.

The FSA has announced that the national implementation of the finalised Basel III standards has been postponed until the fiscal year ending March 2023, in light of the related announcement of the Group of Central Bank Governors and Heads of Supervision (the oversight body of the BCBS).

### **Risk Control Framework for Domestic Banks**

Domestic banks are also subject to the aforementioned risk control framework, but are under less strict requirements than internationally active banks. For instance, domestic banks are only required to meet a minimum capital ratio (the ratio of "core" capital amount to risk asset amount) of 4%; on the other hand, several types of threshold are set as the minimum capital ratio of internationally active banks (eg, 8% for "Tier 1" plus "Tier 2" equity, 6% for "Tier 1" equity and 4.5% for "Common Equity Tier 1"). Domestic banks are not subject to capital buffer requirements and certain other risk management rules.

### **Risk Management and Correction Measures**

Under the aforementioned risk control framework, banks are primarily responsible for managing their risks. The FSA continually monitors the

risk status of banks, and takes early correction measures if a bank fails to meet the minimum capital requirement, such as the order to file an improvement plan, the order to enhance capital and the order to suspend or abolish the whole or part of a business. As a preventative measure, the FSA may also issue an early warning to a bank that satisfies the minimum capital requirement but about which there is still a risk-related concern requiring improvement. With respect to internationally active banks, a failure to meet capital buffer requirements leads to an order from the FSA to restrict capital distribution.

## **9. Insolvency, Recovery and Resolution**

### **9.1 Legal and Regulatory Framework Administrative Procedures**

#### *Ordinary resolution procedures*

The FSA appoints DIC as a "financial administrator" of a financial institution that has excessive liabilities or is at risk of suspending the repayment of deposits, if its operations are extremely inappropriate or if its dissolution seriously hinders smooth fund flows and the convenience of its customers in relevant regions or sectors.

Once appointed as financial administrator, DIC is authorised to control the operations and manage the assets of the failed financial institution. With such authority, DIC is expected to promptly transfer such institution's business, including deposits, to a successor financial institution so that DIC may be able to provide financial assistance to such successor financial institution for the protection of depositors under the Financial Assistance Method. The amount of such assistance is limited to the amount of the insurance proceeds.

If DIC fails to identify a successor financial institution promptly, the FSA directs DIC to establish a bridge bank to which the business of the failed financial institution is transferred for the time being. DIC attempts to re-transfer the business from the bridge bank once a successor financial institution is identified.

Only financial institutions insured under the deposit insurance system (see **6.1 Depositor Protection Regime**) are subject to these resolution procedures.

### *Resolution procedures in the face of systemic risk*

In the face of an extremely serious threat to the maintenance of the credit stability of Japan or relevant regions (systemic risk), the Prime Minister convenes the Financial System Management Council and determines the necessity of financial assistance in relation to a failed or insolvent financial institution (the so-called Item 2 Measure). Unlike the Financial Assistance Method under the ordinary resolution procedures, this Item 2 Measure enables the provision of financial assistance exceeding insurance proceeds, given the necessity to address the emerging systemic risk. Following the determination by the Prime Minister, the FSA appoints DIC as financial administrator, and DIC provides financial assistance exceeding the insurance proceeds.

If the financial institution is insolvent and has failed, and if the systemic risk is too serious to be avoided by the Item 2 Measure, the Prime Minister determines the necessity of the acquisition of shares in such financial institution (so-called special crisis management or Item 3 Measure). Following such determination by the Prime Minister, the FSA directs DIC to acquire shares in the failed and insolvent financial institution, and

thereby substantially nationalises such institution.

Financial institutions that are not eligible for these measures (ie, those which neither are insolvent nor have failed) may still receive a capital injection from DIC to recover their capital adequacy ratio in line with the direction of the FSA (so-called Item 1 Measure).

Only financial institutions insured under the deposit insurance system (see **6.1 Depositor Protection Regime**) are subject to these resolution procedures.

### *A new regime in line with FSB Key Attributes*

The FSB Key Attributes were implemented by amending DIA in 2013, thereby granting the Prime Minister and DIC authority to resolve financial institutions.

Under the amended DIA, the Prime Minister may determine that, following the convening of the Financial System Management Council, it is necessary to take recovery or resolution measures for financial institutions where, without such measures, there is a risk of extreme disruption to the Japanese financial market or other financial systems.

It is noteworthy that not only insured financial institutions (ie, insured banks and other deposit-taking financial institutions – see **6.1 Depositor Protection Regime**) but also Japanese branches of foreign banks, licensed insurance and securities firms and holding companies thereof may be subject to this new regime. DIC plays an important role under this regime, including through the provision of financial assistance to successors of insolvent financial institutions with a view to ensuring the performance of important transactions in the financial market. DIC also provides

liquidity even to solvent financial institutions as necessary.

This new regime is generally in line with the FSB Key Attributes, including the recovery planning, the temporary stay, contractual bail-in mechanism and ex post recovery of costs from the industry.

## Judicial Procedures

The commencement of the aforementioned administrative procedures does not exclude the possibility of judicial procedures being initiated against a failed financial institution in relation to its bankruptcy/rehabilitation. Rather, to achieve the aim of each of these administrative procedures, it is essential to concurrently commence bankruptcy/rehabilitation proceedings and thereby prevent the deterioration of such failed institution's assets and enable it to perform its obligations (eg, with respect to uninsured deposits; see **6.1 Depositor Protection Regime**) to the extent permitted under such proceedings. Although DIA sets out certain provisions addressing the conflict between the administrative and judicial procedures, there are no insolvency preference rules applicable to deposits.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

#### Amendment of Firewall Regulations

As explained in **7.1 Bank Secrecy Requirements (Firewall Regulations)**, banks and securities firms are generally prohibited from sharing material non-public customer information with their affiliates.

In 2021, the Working Group on Capital Market Regulations of the Financial System Council issued a report suggesting there should be an

optimisation of said regulations, to enhance the provision of growth capital to business corporations. In accordance with the report, amendments of subordinate rules and guidelines of the Financial Instruments and Exchange Act became effective on 22 June 2022, and the regulations were relaxed at several points. Among others, information about listed companies, a certain scope of unlisted companies (eg, pre-IPO companies and companies subject to continuous public disclosure obligations), qualified institutional investors and their group companies are excluded from said prohibition. To protect them, such excluded companies are given an opportunity to request that information stops being shared (the so-called “new” opt-out system, which is less burdensome than the current opt-out system).

While relaxing the firewall regulations, to address the concerns of undue influence resulting from the concurrent operations of bank and securities businesses by the same group, this amendment also sets out measures to prevent such undue influence by adding regulations on customer information management (including clarification of the “need to know” principle), enhancing regulatory monitoring on conflicts of interest and implementing co-ordination between financial regulators and competition authorities regarding the abuse of dominant bargaining positions by financial institutions. On the effective date of the amendment, the FSA also established a contact point for collecting information regarding the abuse of dominant bargaining positions by financial institutions.

Following its report in 2021, the working group had discussed the possibility of further optimising the firewall regulations, including the treatment of the information of small and medium-sized enterprises, but the latest interim report



released by the working group on 22 June 2022 did not reach a conclusion on whether to make further changes.

## **Broaden Membership Base of Interbank Payment System**

On 7 October 2022, upon approval of the FSA, the Japanese Banks' Payment Clearing Network (*Zengin* Net) amended its rules for the purpose of broadening the membership base of its interbank payment system (*Zengin* System) and thereby allowing fund transfer services providers to participate in the system.

Since the launch of the *Zengin* System in 1973, the membership base of the system had been gradually expanded from certain banks to include a broad range of deposit-taking financial institutions, while non-banks, which were not permitted to engage in fund transfer services under the Banking Act, were not eligible to be members of the system.

The PSA was enacted in 2009 and, as an exception to the licence requirement under the Banking Act, allowed registered service providers to provide fund transfer services, subject to an upper limit of JPY1 million per transfer. In 2020, the PSA was amended to introduce new types of fund transfer services ("Type I" and "Type III", with the previously existing registrants being categorised as "Type II") and to lift the upper limit for "Type I" subject to the regulator's approval and stringent regulations. Around the same time, an expert panel of the *Zengin* Net, a forum sponsored by BOJ and competition authorities each discussed the possible participation of fund transfer service providers in the *Zengin* System to achieve a low-cost, efficient and transparent system.

Given these developments, in 2020 a task force established by the *Zengin* Net discussed a reform of the *Zengin* System and recommended that the relevant rules be amended to allow the direct/indirect memberships of fund service providers, while taking measures to ensure the stability of the system. Following the recommendation, in 2021 and 2022, the task force and working groups established thereunder continued to discuss the detail of the amendment, which led to the aforementioned broader membership base.

Regulatory guidelines applicable to fund transfer service providers were also recently amended by the FSA, to establish special supervision of participants in the *Zengin* System and thereby maintain the stability thereof. The amended guidelines emphasise the importance of the *Zengin* System as a mission-critical piece of financial infrastructure, and require participants in such system to have a sound financial basis and to establish risk and business continuity management in a proper manner.

As for the system risks management, the previous guidelines had already set higher standards only for "Type I" fund service providers; after the amendment, the same higher standards are also applicable to "Type II" and "Type III" providers if they participate in the *Zengin* System. By participating in the system as a direct member, fund transfer service providers would be able to directly transfer and receive funds from other participants.

In addition to said amendment, the *Zengin* Net continues to consider the establishment of a new connection method (API gateway), to make the system more convenient and reduce the burdens on existing and new members. Combined with other initiatives, such as Cotra (a separate

small-value fund transfer services launched on 11 October 2022, which is connected to the *Zengin* Net) and the introduction of a digital salary payment system that is separately being discussed, the amendment is expected to contribute to more efficient payment and settlement systems, and to the move towards a cashless society in Japan.

## **New Regulatory Framework for Stablecoins**

On 3 June 2022, the Diet passed a bill to amend the Banking Act and the PSA, with the purpose of introducing a new regulatory framework for intermediaries of fiat-backed stablecoins. This amendment was promulgated on 10 June 2022 and will enter into force within one year after the date of the promulgation.

The new framework regulates fiat-backed stablecoins. If holders of stablecoins have a right to request the issuer to make a redemption with fiat currencies, such stablecoins are subject to the new framework. Other stablecoins with a similar nature may also be subject to the same framework.

Under the current regulatory framework, issuers of such fiat-backed stablecoins are limited to banks, fund transfer service providers and trust banks/companies that are licensed by or registered with the regulator.

The amendment focuses on intermediaries of fiat-backed stablecoins. After the enforcement of the amendment, intermediaries involved in the issuance, redemption, transaction or custody of fiat-backed stablecoins may be required to make a new type of registration with the regulator under the amended Banking Act or the amended PSA, depending on the detail of their services, unless their activities are covered by existing licences. For this new type of registra-

tion, the intermediaries need to satisfy certain regulatory standards, such as compliance with the conduct rules for AML/CFT, the execution of a contract with issuers to agree on the allocation of each party's burden for indemnification to customers and other statutory matters, and the establishment of internal control systems for, among others, proper treatment and security of customer information, management and supervision of outsourcing.

The registrants are generally permitted to intermediate fiat-backed stablecoins issued by entities licensed in Japan. It is noteworthy that, according to a draft enforcement ordinance released in December 26, 2022, the registrants may also intermediate foreign fiat-backed stablecoins by satisfying certain criteria. Among others, the regulatory framework in the foreign country must be equivalent to that in Japan, and the registrants must take measures to avoid losses incurred by holders of such stablecoins by promising to buy back such stablecoins upon bankruptcy of the issuer. The draft enforcement ordinance also indicates a quantitative limitation on such stablecoins handled by the registrants. According to draft guidelines, even after the amendment, foreign issuers are not permitted to issue and redeem by themselves fiat-backed stablecoins to Japanese residents. After the public comment process, the final form of regulations are expected to be published by around the spring of 2023.

## **Development of Sharing of AML/CFT Systems and Services**

The amendment of the Banking Act and the PSA explained above also aims to develop the sharing of AML/CFT systems and services among financial institutions. Under the amended PSA, service providers are required to obtain approval from the regulator to provide transaction filter-

ing and monitoring services delegated by certain financial institutions. By introducing the approval system, the regulator will be able to conduct inspection and supervision of such service providers, to ensure the quality of their business operations. According to a press release of 13 October 2022, the Japanese Bankers Association has decided to establish a corporation that provides AI scoring on risks of alerts issued by each bank's transaction monitoring system and support for the sophistication of each bank's AML/CFT operations, subject to approval under the amended PSA.

## 11. ESG

### 11.1 ESG Requirements

The Banking Act does not set forth ESG requirements to be satisfied by a licensed bank; however, as discussed in **4.1 Corporate Governance Requirements**, under the existing regulatory guidelines, listed banks and listed Bank Holding Companies are required to comply with "Japan's

Corporate Governance Code – Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term", issued by the Tokyo Stock Exchange, Inc. Accordingly, a listed bank or a listed Bank Holding Company needs to take ESG requirements in the code into consideration. In 2021, the code was amended to request listed companies to establish a basic policy and public disclosure procedures regarding sustainability.

On 12 July 2022, the FSA published a new guidance titled "Supervisory Guidance on Climate-related Risk Management and Client Engagement" as part of its area-specific supervisory guidance. The guidance does not require banks and other financial institutions to comply with specific rules; rather, it clarifies the viewpoints of supervisory dialogues regarding financial institutions' management of climate-related risks as well as engagement with and support for their clients regarding the clients' climate-related risks and opportunities, such as the provision of sustainable finance.

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