Review of Banking Regulations which Contribute to the Stability of the Financial System, etc.†

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Working Group on Framework of Regulations on Banks which Contribute to Stability of the Financial System, etc.

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(As of January 1, 2013)

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	National Association of Labour Banks
	The Norinchukin Bank
	The Life Insurance Association of Japan
	The General Insurance Association of Japan
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Introduction

Amid persistent instability in international financial and capital markets, it has become important to ensure the protection of depositors and the stable financial system in Japan. Another key issue is to review regulations for ensuring the financial soundness of banks in line with international regulatory standards.

Furthermore, in light of the experience of the recent global financial crisis triggered by the failure of Lehman Brothers, etc., an international agreement was reached with respect to the development of new frameworks in relation to an effective resolution regime for financial institutions. Since then, progress has been made in various countries for the development of concrete systems. In Japan, it is necessary to establish a framework for an orderly resolution regime for financial institutions in order to address risks that may spread across financial markets, etc.

While there is a need to respond to these global trends, at the same time, from the perspective of encouraging further growth of Japan's economy and financial industry, there is also a strong need to take an active approach aimed at further strengthening the functions of the Japanese financial industry, such as promoting financial institutions to provide capital to small and medium-sized enterprises (SMEs) and to provide support for Japanese companies expanding their business overseas.

In view of these circumstances, on April 11, 2012, the Minister of State for Financial Services referred the following problems to the general meeting of the Financial System Council for deliberation: how foreign bank branches should be regulated; how large exposure rules should be; other measures necessary for the stability of the financial system; and measures for further strengthening the functions of Japanese financial institutions.

The Working Group was established to consider these questions, and has met 14 times in total thus far to deliberate on: (i) regulations governing foreign bank branches; (ii) large exposure rules; (iii) an orderly resolution regime for financial institutions; and (iv) measures for further strengthening the functions of Japanese financial institutions. This report summarizes those findings.

1. Regulations governing foreign bank branches

At present, a foreign bank is permitted to accept retail and wholesale deposits in the Japanese market through both subsidiaries and branches. The scope of approved business does not depend on whether the entities used are branches or subsidiaries. At the same time, foreign bank branches are not subject to the regulations related to the stated capital, and they are not subject to application of the Act on Special Measures Concerning Proceedings of Financial Institutions, etc. (Act on Special Measures for Reorganization).

In order to protect depositors in Japan and to ensure the stability of the financial system, the current status needs to be reviewed. At the same time, in reviewing the regulations, consideration should be given to the need for international cooperation in any cross-border recovery and resolution planning of financial institutions, and to not excessively impeding the business models of foreign bank branches.

For this reason, it is appropriate that the review be conducted as follows.

(1) Form of market entry and scope of business

As mentioned above, Japan does not impose any regulations on foreign bank branches concerning the scope of business, regardless of their form of market entry. Furthermore, there are no separate statutory regulations for foreign bank branches which limit risks associated with transactions conducted by the branches, including fund transfers to the head office.

Given that Japan has not made reservations about restrictions on the services which can be performed by foreign bank branches in view of the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS), it would be difficult to make revisions such as not permitting branches to accept any retail deposits whatsoever. Furthermore, as mentioned below, there are also problems in imposing the obligation on foreign bank branches to maintain assets in Japan, the capital adequacy requirement, and large exposure rules.

However, for the purpose of ensuring the financial soundness of foreign bank branches, with regard to the acceptance of retail deposits through branches and to the management of funds, including fund transfers to their head office, etc., it is appropriate to clarify licensing standards and the daily supervisory viewpoints that already exist for foreign bank branches from a prudential perspective, given the following:

- With respect to foreign bank branches, there is a certain limit to grasping the circumstances of the entire group, including the head office, because it is not possible for Japan to conduct supervision as the home authority;
- In cases where a foreign bank branch conducts transactions with other companies within its group, there is an issue about whether the branch is sufficiently able to exert adequate control over the attribution of risks associated with the transactions, including risks related to fund transfers to the head office; and
- Under the WTO's GATS Annex on Financial Services, member nations shall not be prevented from taking measures for prudential reasons.

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(2) Capital adequacy requirement and prompt corrective measures

Under current regulations, standards for determining the soundness of management (capital adequacy requirements) have been established for foreign bank branches as well as for domestic banks, and they could be required to implement prompt corrective measures based on that adequacy. However, at present, no standards for capital adequacy ratios in relation to foreign bank branches have been applied, as they are yet to be established.

With regard to imposing a capital adequacy requirement on foreign bank branches, there are issues from the perspective of effectiveness: depositors in Japan may not be repaid ultimately in the event where the parent foreign bank was to fail, unless the foreign bank branch actually holds assets in Japan, even if it has assets on its balance sheet. Moreover, in other countries, there are hardly any apparent examples of capital adequacy requirements being imposed on a branch-by-branch basis. In view of these factors, at this point, it is appropriate to give careful consideration to this point.

(3) Order and obligation to maintain assets in Japan

Under current regulations, in response to overseas activities by Japanese banks and the expansion of business operations by foreign bank branches, the authorities are able to order banks and foreign bank branches to maintain a certain portion of their assets in Japan if they deem it necessary for the protection of depositors, etc. in Japan or otherwise in the interests of the public.

From the perspective of ensuring the effectiveness of such orders, the current penalty for the violations (fines of up to 1 million yen) is insufficient, and so it is appropriate to increase the penalty.

Furthermore, in addition to the order to maintain assets in Japan as a response to emergency situations, a possible provision for non-emergency times is, for instance, to require foreign bank branches to maintain assets in Japan with respect to a certain portion of an amount equivalent to their liabilities, such as deposits received in Japan.

Nevertheless, in view of the current environment, which requires international cooperation in any cross-border recovery and resolution planning of financial institutions, indiscriminately requiring the maintenance of assets in Japan by law may not necessarily be appropriate at this point. Furthermore, given that current foreign bank branches have diverse business models, and that there are also issues in ensuring effectiveness, it is appropriate that future consideration continue to be given to how assets should be maintained in Japan.

(4) Retained earnings reserve regulations

Under current regulations, foreign bank branches are required to record one-tenth of their net income as retained earnings, and to accumulate it until it reaches 2 billion yen. In addition, they are required to reserve assets equivalent to that amount of retained earnings.

However, from the perspectives of ensuring financial soundness and protecting depositors, it would appear that the regulation is inadequate since it requires assets to be reserved only after net income has been earned.

Therefore, instead of the current regulation, it is appropriate to require foreign bank branches to continuously reserve assets equivalent to the minimum capital requirement for domestic banks (2 billion yen)[1] after the banking license is given.

(5) Liquidity regulations

While Basel III liquidity requirements for internationally active banks are regulated on a consolidated basis by the home authority, some major countries are considering the idea of imposing liquidity regulations on foreign bank branches as well. Given this, it is appropriate to continue examining the introduction of liquidity requirements for foreign bank branches while taking into account future trends, etc. in major countries.[2]

(6) Deposit insurance system

Deposits held by foreign bank branches are not currently covered by deposit insurance in Japan.

From the perspective of protecting depositors (in particular, the retail depositors) in Japan, it seems that the future deposit insurance system in Japan should be designed to cover deposits held by foreign bank branches.

On the other hand, foreign bank branches have considerably diverse business models and internal control systems, and as abovementioned, there are issues in imposing regulations for ensuring financial soundness, including the obligation to maintain assets in Japan. Therefore, it is appropriate to also continue examining the enrollment of foreign bank branches into the deposit insurance system in Japan as a future issue.

It is appropriate to draw conclusions on the specific treatment of foreign bank branches with regard to the deposit insurance system in the future, while taking into account such factors as future trends in the business models and internal control systems of foreign bank branches as well as how assets should be held in Japan.

(7) Application of the Act on Special Measures for Reorganization

Under current regulations, the authorities are allowed to file a petition for special liquidation under the Companies Act in addition to disqualification of the licenses of foreign bank branches. At the same time, because the Act on Special Measures for Reorganization is not applicable to foreign banks related to foreign bank branches, the authorities are not entitled to file a petition for commencement of reorganization proceedings, rehabilitation proceedings, bankruptcy proceedings or the right to file a petition for a temporary restraining order against such foreign banks. From such perspectives as protecting the rights of depositors, etc. in Japan and ensuring the smooth progress of the proceedings, it is appropriate that the authorities be given such powers.[3]

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1 It is appropriate to establish a transitional measure for existing foreign bank branches.
2 Note that Basel III liquidity requirements are scheduled to be phased-in starting from 2015.
3 In addition to the above, at present, no provisions have been established making foreign bank branches subject to the system of financial receiver or enabling the Deposit Insurance Corporation of Japan to participate in bankruptcy proceedings such as by preparing tables of depositors at foreign bank branches. Since these systems are predicated on the involvement of the Deposit

(8) Obligation to provide information to depositors, etc.

According to the individual provisions of the current Banking Act, foreign bank branches are not obliged to explain to depositors, etc. that deposits held by foreign bank branches are not covered by the deposit insurance system in Japan.

Since the enrollment of foreign bank branches into the deposit insurance system is difficult at this point, it is necessary to specify information on the risks for depositors in the unlikely event that a foreign bank fails.

Therefore, it is appropriate to impose on foreign bank branches the duty to explain to customers that:

- Deposits held by foreign bank branches are not covered by the deposit insurance system in Japan;
- In the unlikely event that the foreign bank fails, any repayment may not be swiftly made, even supposing that deposits were (partially) refunded, etc.[4]

2. Large exposure rules

For the purpose of ensuring the soundness of business operations of banks, etc.[5] in light of the diversification of risks associated with their assets and of the broad and appropriate allocation of their credit, the large exposure rules in Japan set an upper limit (a certain percentage of the equity capital of bank groups and bank holding company groups) on the total amount of credit exposures to a single counterparty or a group of connected counterparties

One issue for the large exposure rules in Japan is that they may not have been able to completely keep up with the spread and sophistication of financial technology, such as the development of derivatives, the complicated transactions involving multiple traders, and the diversified and complicated group structures resulting from mergers and acquisitions (M&As) or business tie-ups. Based on a similar awareness of the issue, the Financial Sector Assessment Program (FSAP) report on Japan, which was released by the International Monetary Fund (IMF) in August 2012, evaluates Japan's large exposure rules as being materially noncompliant (MNC).

For this reason, it is appropriate that the review be conducted as follows.[6,7]

Insurance Corporation of Japan, it is appropriate to continue examining this in conjunction with the enrollment of foreign bank branches into the deposit insurance system.

4 In cases where the deposits held by a foreign bank branch are covered by the deposit insurance system in the home country of the foreign bank, it is appropriate that an explanation to this effect also be made. Furthermore, practical deliberation is needed within the authority regarding providing the explanation that the ultimate resource of solvency (financial soundness) is ascribed to entire foreign banks (which are supervised by the home authority, while a foreign bank branch is supervised by the Japanese authority).

5 Meaning a bank or other financial institution that accepts deposits and savings; the same shall apply hereinafter.

6 It is appropriate that the same review also be conducted for cooperative financial institutions.

(1) Scope of credit exposures

(i) Unexecuted balance of committed credit lines

The unexecuted balance of commitment lines of credit is currently excluded from the scope of regulation. However, it is appropriate, in principle, to include the unexecuted balance within the scope of regulation, because banks, etc. are required to provide loans at the request of customers and so the unexecuted balance of commitment lines could also be regarded as credit already granted, and large exposure rules should be conservative.

In view of examples in major countries, it is appropriate that commitment lines of credit that are unconditionally cancelable at any time, or that provide for automatic cancellation due to deterioration in a borrower's creditworthiness (limited to those where the unexecuted balance of commitment lines does not exceed the regulatory upper limit of credit exposure), for instance, be excluded from the scope of application.

(ii) Inter-bank transactions (e.g. call loans), and inter-bank deposits

Inter-bank transactions and inter-bank deposits are currently excluded from the scope of regulation. The reason for this is, supposing that they were within the scope of application, a situation could arise where the fund-flow management of financial institutions would be adversely affected and the soundness of their management would instead be impeded as they experience a shortage of funds.

Nevertheless, supposing that the borrower or the financial institution accepting the deposits were to fail, it is also conceivable that the lender or the bank holding the deposits would incur a loss, thereby undermining its financial soundness. At the same time, consideration needs to be given to such factors as risk characteristics and the true state of the transactions.

Based on the above, in principle, it is appropriate to include inter-bank transactions and inter-bank deposits within the scope of regulation, and to exclude the following transactions, for instance, from the scope of application.

- Short-term exposures related to fund settlement, etc.[8]
- Transactions between financial institutions within the same group that satisfy certain conditions[9]
- Deposits placed with a central organization (federation) consisting of cooperative financial institutions
- Secured calls as credit granted directly to money-market dealers

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[7] It is appropriate to establish transitional measures in cases where there would be a significant impact on business practice.

[8] In terms of the specific nature of "short-term," the authorities will need to give practical consideration to the question of whether to include exposures that are overnight or longer in duration while it would seem that intraday exposures are included.

[9] The authorities will need to give practical consideration to the meaning of "certain conditions."

- Credit granted to the Bank of Japan, etc.
- Credit granted by a bank holding company to strengthen the equity capital of a subsidiary bank (subordinated loans)

(iii) Amount equivalent to the credit risk in derivative transactions

The amount equivalent to the credit risk in derivative transactions is within the scope of regulation, but since there is a need for consideration focusing on the technical issues, as a transitional measure, this amount has been excluded from the scope of application.

With respect to the amount equivalent to the credit risk in derivative transactions, along with major countries, it is appropriate to include within the scope of regulation an amount which is determined using the same technique as that for calculating risk assets in the capital adequacy requirement.[10]

(iv) Publicly offered corporate bonds

The subscription of corporate bonds by banks, etc. substantially has the same economic effect as the lending of long-term funds to the issuing company. Therefore, this is within the scope of regulation. However, the regulation has not been applicable to the holding of corporate bonds other than privately placed ones for the time being, because it has been assumed to be easy to avoid credit risk by reselling them.

Now, it is appropriate that publicly offered corporate bonds be within the scope of the regulation, because shares are within the scope of application regardless of whether they are listed or not, and it is, in reality, considered to be difficult to avoid risks by reselling corporate bonds before the failure of issuing companies.

(v) Credit exposures in the trading book

While commercial papers (CPs) for trading (short-term corporate bonds) are within the scope of regulation, they have been excluded from the scope of application for the time being as a transitional measure. Furthermore, securities for trading that are recorded on the “trading book” are all excluded from the scope of application under current regulations.

In foreign countries, the trading books are, in principle, also within the scope of regulation, as well as corporate bonds. Since there is a risk of failure regardless of the purpose for which they are held, it is appropriate to also make the credit exposures in the trading book subject to regulation.

(vi) Other matters

[10] Under the system of capital adequacy requirement, “regarding transactions made under a legally valid bilateral netting contract, the amount of costs after calculating the net value may be used” as the value of the credit equivalent.

While it is internationally recognized that the scope of credit exposures should be broadened, Japan has regulated target credit exposures individually for each account title of banks. As such, the authority needs to verify practically whether there is any credit exposures besides those described above, which ought to be included in the scope of regulation.

(2) Scope of aggregation of creditors and counterparties

Taking into account the feasibility of creditors to understand the scope of counterparties to be aggregated, based on the parent-subsidiary relationship (more than 50% of voting rights) under the Commercial Code (1998), the scope of counterparties to be aggregated has been regarded as those counterparties with which there is a capital relationship involving a control interest by means of shares or equity investment.

While it is considered that the scope of aggregation should be determined in a substantial way, it is also recognized that consideration needs to be given to the fact that not all companies prepare consolidated financial statements.

For this reason, in case of large companies which are required to prepare consolidated financial statements and companies which submit annual securities reports, in addition to any subsidiary companies in which they hold more than 50% of the voting rights, it is appropriate to extend the scope of counterparties to be aggregated to affiliated companies and any subsidiary companies based on an effective control basis (at least 40% of voting rights + control over the decision-making body, etc.).

In addition, it is appropriate to establish discipline in order to prevent any evasion of regulation, such as by means of using multiple names or circumventive financing.[11]

(3) Treatment of credit granted within the group by a bank or bank holding company

At present, while credit granted within a group by a bank or bank holding company as well as credit granted to persons outside the group is within the scope of regulation, the subsidiaries of the bank or the bank holding company are excluded from the scope of aggregation of counterparties in consideration of the efficiency of distributing funds within the group.

In light of the experience of the recent financial crisis, discussion in major countries has moved toward including credit granted in a group within the scope of regulation. Based on this discussion, with respect to Japan’s current regulations, which impose large exposure rules on the subsidiaries of banks and bank holding companies, while keeping a close eye on the trends of discussion in major countries, ongoing consideration is needed with regard to whether there are any points for further

[11] Specifically, rules could be established stating that, in the event that credit is divided by name or financing provided indirectly as a form of evading regulations, the regulations shall be applied by regarding the party that has effectively granted the credit as the creditor.

revision.

However, with regard to credit granted by affiliated companies of a bank or bank holding company, it is possible that this may interfere with financial group restructuring such as M&As[12] since it is aggregated in such entities' capacity both as a creditor and a counterparty.

For this reason, it is appropriate that an affiliated company of a bank or bank holding company be allowed to grant credit tailored to specific individual cases under an approval system.

(4) Method of calculating credit exposures

At present, the value of credit exposures for on-balance sheet transactions is calculated using the balance sheet amount (book value), and the value of the bank's own deposit collateral and collateralized government bonds is subtracted from the value of the credit exposures. Furthermore, in cases where the balance sheet amount of securities exceeds the book value, the difference between them is subtracted from the value of the credit exposures. Meanwhile, collateralized real estate and guarantees by third parties are not taken into account at all.

In view of the fact that large exposure rules are measures for setting an upper limit on the exposure to creditors (not multiplied by risk weight), it is basically appropriate to consider the value of credit granted which is within the scope of regulation conservatively.

While off-balance sheet transactions are not currently included in the scope of regulation and the method for calculating the amount equivalent to credit exposures has not been stipulated, it is appropriate to base it on the method for calculating the amount equivalent to credit risk in the capital adequacy requirement in view of the examples in major countries.

(5) Limit on the amount of credit exposures

In cases where the counterparty is a group, the limit on the amount of credit exposures is set at 40% of capital,[13] but the IMF's FSAP report evaluates and advises that this is higher than the international standard (25%).

Even if the limit was amended to the international standard (25%), considering that

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12 Supposing that the parent company of a foreign financial group which behaves as the affiliated company of a bank holding company grants credit to a consolidated subsidiary company or affiliated company of the said parent company. This act is subject to large exposure rules, and so it has been indicated that the act would impede an M&A or other form of financial group restructuring overseas.

13 Equity capital which forms the basis for calculating the limit on the amount of credit exposures is the sum of "Tier 1 + Tier 2" capital based on the consolidated financial statements and calculated exclusive of affiliated companies, plus the amount equivalent to "Tier 1 + Tier 2" capital of the affiliated companies. Note, though, the IMF's FSAP report states that the equity capital which forms the basis for calculating the limit on the amount of credit exposures should be either "Tier 1 or core Tier 1" capital.

the impact on practical business would be confined to a certain extent, it is appropriate to lower the amount of credit exposures to groups of connected counterparties to the international standard (25%).

(6) Response when the limit on the amount of credit exposures is exceeded

Currently, in cases where the amount of credit granted by a bank, etc. to the same person exceeds the limit of credit exposures, the bank is permitted to exceed the credit limit if there is compelling reason and the approval of the Prime Minister has been obtained. However, compelling reasons are specifically enumerated, and because the permission is based on specific individual cases, it does not allow for flexible responses to be taken. Given this, it is appropriate to establish a basket clause so as to allow individual cases to be exempted from application.[14]

(7) Large exposure rules on foreign bank branches

Under current regulations, large exposure rules (non-consolidated regulations for creditors only) are imposed on foreign bank branches based on the equity capital of the foreign bank. However, since notification of the benchmark capital has not been stipulated, in reality, this regulation has not yet been applied.

Currently, a supervisory authority in the home country of a foreign bank is generally in charge of application of large exposure rules based on the capital of foreign banks. Consequently, it is also appropriate for Japan to give due consideration to applying the regulation.

With regard to the application of large exposure rules on a branch-by-branch basis (in this case, making fund transfers to head office subject to regulation), taking into account that a fund transfer made by a foreign bank branch to head office is an exchange of funds within the same corporation, it might be hard to describe that applying the approach taken under the current large exposure rules on a branch-by-branch basis is in line with actual circumstances.

3. Orderly resolution regimes for financial institutions

During the recent global financial crisis triggered by the failure of Lehman Brothers, etc., it was revealed that there is a potential risk that distress and failure of systematically important financial institutions may spread across financial markets and cause a serious impact on the real economy.

In light of this experience, discussions were advanced internationally for the establishment of a framework which would enable orderly resolution regimes if by any

[14] Possible instances where approval would be given for exemption from application of the regulation include: (1) in the case of interbank transactions and interbank deposits, cases where it is recognized that, if the regulation was applied immediately, a situation could arise where the cash-flow management of the financial institution would be adversely affected and the soundness of its management would instead be impeded as it experienced a shortage of funds; and (2) cases where it is recognized that, even if the financial institution temporarily exceeded the limit on the amount of credit exposures, there would be no material impediment to its soundness.

chance a financial institution ends up in failure. In October 2011, the Financial Stability Board (FSB) formulated the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes"), which was internationally agreed on at the G20 Cannes Summit in November 2011.

In parallel with the progress made in international discussions, new comprehensive frameworks for effective resolution regimes for financial institutions have been established in major countries. Specifically, in the United States, the Dodd–Frank Act was enacted and came into effect in 2010, providing for a system which enables an orderly resolution regime. In the United Kingdom, under the 2009 Banking Act, a system of effective resolution regime has been developed under the universal banking system. Furthermore, in the European Union, legislative proposals, including a draft directive, were published in 2012 for the development of a recovery and resolution system for deposit-taking banks and investment firms.

In Japan, reflecting these global trends, it is necessary to establish a framework for orderly resolution regimes of financial institutions in order to address risks that may spread across financial markets, etc.

Appropriate specifics of the framework for orderly resolution regimes for financial institutions would be as below.

(1) Scope

Considering the experiences of the recent global financial crisis triggered by the failure of Lehman Brothers, etc., it is important that a safety net be built for financial markets and the entire financial industry, for the purpose of preventing any rapid loss of confidence in the financial markets, any disruption at the time of a bank failure or any impact on the real economy, and for the financial system to maintain its resilience.

In particular, with respect to financial institutions other than deposit-taking financial institutions, given that no frameworks have been established by which a relevant orderly resolution could necessarily be systematically secured, and in light of the indications contained in the "Key Attributes" and in IMF/FSAP reports, a new system needs to be established to address a crisis that may spread globally across financial markets, etc.

With regard to deposit-taking financial institutions as well, in addition to the current financial crisis response measures, establishing a system which allows for the protection of debt, etc. needed for stabilizing the financial system would enable a flexible response on a case by case basis which takes the circumstances of the case into account will be possible.

For this reason, it is appropriate to make these measures cover financial institutions, including deposit-taking financial institutions, insurance companies, financial instruments business operators, and financial holding companies.

Specifically, the scope should be determined on the basis of financial group units, taking into account such factors as: the need to establish a framework for orderly resolution regimes for financial institutions in order to deal with a crisis that could potentially spread through the market, etc; the scope at which moral hazard can be reduced through regular financial supervision; and the scope to which financial supervision extends under industry law and regulations, etc.

(2) Procedure for initiating the orderly resolution mechanism of financial institutions

In initiating the orderly resolution mechanism, as is the case with the financial crisis response measures, since a high–level judgment is required, it is appropriate that, based on the deliberation of the Financial Crisis Response Council (whose members are: Prime Minister, Chief Cabinet Secretary, Minister of State for Financial Services, Minister of Finance, Governor of the Bank of Japan, and Commissioner of the Financial Services Agency), the Prime Minister confirm the need to implement an orderly resolution mechanism for financial institutions for the purpose of stabilizing the financial system.

(3) Details of measures

Where it is considered necessary to prevent severe market disruption, it is appropriate that the Deposit Insurance Corporation of Japan, which has the systems and know-how on the resolution process, be involved in financial institutions as necessary (oversight, orders, and management, sale and transfer of property, etc.) so that the property of the financial institution is managed, sold and transferred appropriately.

At the same time, it is important to coordinate with insurance policyholder protection corporations and investor protection funds. Furthermore, the Deposit Insurance Corporation of Japan's functions (for example, on-site inspections) and its system also need to be strengthened.

When the financial institutions are not in a state of insolvency, measures are needed to promote the stability of markets by means including having the Deposit Insurance Corporation of Japan provide liquidity and ensure that all its debts are fulfilled as per their original contract, while promoting the reduction and elimination of its market transactions, etc. Moreover, with the aim of bringing oversight, etc. to an end, measures are needed which would enable the Deposit Insurance Corporation of Japan to subscribe preferred shares, etc., sell assets and transfer businesses, etc.

Furthermore, in cases where the financial institution is in the state of insolvency, etc., measures are needed to have its debts and other obligations, which are critical for stabilization of the financial system, fulfilled (and to have other debts, etc. basically liquidated) by promptly transferring them to an acquiring financial institution, etc. and, at the same time, by providing financial assistance. Under an orderly resolution regime for financial institutions, it is also appropriate to exercise bail-in options prescribed in contracts, etc. (writing down the debt principal, or converting it into equity, etc.) in order to require creditors of the financial institution to also share the burden.

With a view to stabilization of the financial system, it is appropriate to allow these measures to be implemented for both financial holding companies and their subsidiary financial institutions.

In times of crisis, the following measures are needed as the main mechanisms for swift orderly resolution, such as through the utilization of business transfers, while avoiding the emergence of any counterparty risk or the loss of any market functions, while also preventing any decline in the corporate value of the financial institution.

- Transfers of business, etc. based on permission in lieu of a special resolution at a shareholders meeting, etc. in cases where the financial institution is not insolvent
- Request for the temporary stay of debt collection
- Response to petition by creditors for insolvency proceedings or to compulsory execution, etc.
- Purchase of assets from the relevant financial institution
- Removal of the requirement for the consent, etc. of creditors for the transfer of debt.
- Simplification of procedures for the transfer of customer accounts for securities, etc.
- Satisfaction of obligations, etc. needed for an orderly resolution regime at the commencement of insolvency proceedings in order to maintain financial functions
- Empowerment of the authorities with the right to file a petition for insolvency proceedings (Civil Rehabilitation Act, etc.) against a financial instruments firm or a foreign bank in relation to a foreign bank branch
- Authorization for the exercise of bail-in options prescribed in contracts, etc.

(4) Temporary stay of the early termination clause

In cases where an orderly resolution regime was implemented for a financial institution with a large number of derivative contracts, etc., if large volumes of the derivative contracts, etc. were terminated at once, any counterparties that have conducted hedge transactions, etc. could be affected, leading to the destabilization of financial markets.

The early termination of derivative transactions, etc. could also result in the rapid impairment of the asset value of the financial institution, and this in turn could work to make the orderly resolution regime for the financial institution difficult.

For this reason, there has been international agreement with respect to utilizing the power of the authorities to restrict the exercise of the early termination clause, and moves to legislate this are underway in major countries.

In view of these points, with regard to the effect of terminations attributable to the orderly resolution regime for a financial institution or to reasons incidental to this, it is appropriate to allow the effect to be changed or stayed to the extent necessary for preventing severe market disruption. It is also appropriate that similar measures be implemented for the financial crisis response measures in the current Deposit Insurance Act.[15]

[15] With regard to business operators that provide systems, etc. to financial institutions, consideration

In this case, it is appropriate to prevent the following acts from taking legal effect: the Act on Collective Clearing of Specified Financial Transactions Conducted by Financial Institutions, whereby derivative transactions, etc. are (forcibly terminated and) netted against each other; the Bankruptcy Act; the Civil Rehabilitation Act; and the Corporate Reorganization Act, which allow derivative transactions, etc. to be terminated.

(5) Funding for resolution

If the liquidity of a financial institution dries up, the institution could not continue operating and its corporate value would be impaired, which would also have an impact on counterparties. In order to prevent this, it is appropriate to enable the Deposit Insurance Corporation of Japan to provide government guarantee for its funding so that it can provide liquidity quickly.

With respect to the burden of costs associated with an orderly resolution regime for financial institutions, it is appropriate that, in principle, losses be borne ex post by the financial industry, which is based on the idea of building a safety net by financial markets and the entire financial industry, as with the current financial crisis response measures, in the event that losses are incurred.[16] However, in exceptional cases, such as those where there is a risk that imposition of the burden ex-post could constitute an extremely significant hindrance to the stability of the financial system, financial support by the government will also need to be available.

Given the crisis response nature of the mechanism, it is appropriate that the Deposit Insurance Corporation of Japan record its expenses for orderly resolution regimes on its Crisis Management Account.

It is appropriate to adopt a method of calculating burden shares on the basis of objective numerical values, such as the amount of debt. In calculating burden shares, it is appropriate to consider those methods after taking into account such factors as the nature of the services of financial institutions, the benefits received from the regimes, and the existing safety net frameworks.

(6) Other matters

Once a system is established which enables orderly resolution regimes for financial institutions, while bearing this system in mind, it is necessary to continue to promote the formulation of recovery and resolution plans for financial institutions that engage in large-scale complex businesses, in order to implement the procedures smoothly, and to monitor the trading situation of the financial institutions both within and outside the group in a timely fashion, and to promote the development of systems.

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ought to also be given to measures for ensuring that the systems needed for operation of financial institutions continue to be provided without permitting early termination of system contracts, etc.

[16] With regard to the burden of costs, given such issues as the calculation of required amounts, it seems that burdens should be imposed ex post, not ex ante.

With regard to cross-border resolution of financial institutions—in particular, resolution of the local subsidiaries or branches of a foreign financial institution in Japan or resolution of the local subsidiaries, or branches of a Japanese financial institution in an overseas country—it is appropriate that information be shared on recovery and resolution plans by means including through discussion between supervisory authorities at FSB or other forums or dialogue between agencies implementing resolution regimes, while ensuring international collaboration and maintaining the stability of Japan's financial system.[17]

4. Measures for further strengthening the functions of Japanese financial institutions

(1) Restriction on banks, etc. holding voting rights (known as the "5% rule")

(i) Basic concept

At present, it is provided that a bank, etc. and its subsidiaries shall not hold in total more than 5%[18] of voting rights in a domestic non-financial company held by all of the shareholders, etc.

The 5% rule was established for the purpose of enforcing the intended aim of the prohibition of other business, namely, to prevent the financial and management soundness of a bank, etc. from being undermined by the bank, etc. engaging in a business other than its main business. The rule was established in 1998, reflecting the fact that banks in Japan had been virtually required to assume responsibility for the liabilities of companies over which they had managerial control (known as the "responsibility of the parent bank") and that this had been one of the primary causes of a financial crisis.

The 5% rule continues to be an important measure for ensuring the soundness of banks, etc. and that such a situation would never give rise to a financial crisis emerging from Japan

On the other hand, in view of the fact that there is a shortage of capital providers in regional economies, it is also an important policy issue to develop an environment in which banks, etc. can play their role as capital providers.

For this reason, in implementing these revisions while basically maintaining the current regulatory framework, in cases where there is a real demand in regional economies for the provision of capital, it is appropriate to allow banks, etc. to flexibly provide capital, while also being mindful that their financial soundness is ensured.[19,20]

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17 With regard to cross-border resolution, it is important that the Deposit Insurance Corporation of Japan also shares necessary information for orderly resolution regimes for financial institutions, etc. and otherwise engages in necessary international cooperation.

18 15% in the case of bank holding companies, and 10% in the case of cooperative financial institutions.

19 It is also appropriate to implement similar measures for bank holding companies and cooperative

In cases where a bank, etc. is allowed to directly hold the voting rights, in addition to the holding of voting rights by a specialized investment subsidiary of the bank, etc., it is appropriate to be more restrictive on the requirements of applicable companies of which the bank, etc. directly holds voting rights than in cases where voting rights are held by a specialized investment subsidiary, in light of ensuring the financial soundness of the bank, etc.

(ii) Upper limit on holding voting rights

With regard to the upper limit on holding voting rights, in view of the basic concept described above, rather than uniformly lifting the limit to a certain degree irrespective of the nature of the target enterprise's business, it is important to relax the restriction only in cases where contributions to the corporate restructuring or revitalization of region can be expected while considering the impact on the financial soundness of the bank, etc.

For this reason, it is appropriate to maintain the current regulations pertaining to the upper limit on holding voting rights (5%).

(iii) Exceptions to the 5% rule

i) Voting rights acquired and held as a limited partner

Acquiring and holding voting rights as a limited partner of an investment limited partnership is regarded as an exception to the 5% rule, except where the limited partner: (i) can exercise the voting rights; (ii) give instructions pertaining to exercise of the voting rights to an unlimited liability partner; or (iii) hold the voting rights for more than ten years.

The 5% rule is based on voting rights and was established to enforce the intended aim of the prohibition on other business. From this perspective, if instances where voting rights can be effectively exercised are excluded, the effectiveness of the regulation may be satisfactorily ensured in the same way as the current system, even without restricting the holding period.

For this reason, it is appropriate to remove the condition of the period of time that is an exception to the 5% rule for voting rights acquired and held as a limited partner.

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financial institutions. The relevant authorities need to give consideration to the 5% rule set forth in the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade.

[20] These revisions will result in an increase in the risks borne by banks, etc.; shares may fall in price or lose value during the time that the bank, etc. holds them, and the bank, etc. may incur a loss when it disposes of the shares. For this reason, in accordance with these revisions, banks, etc. will be required to properly examine business revitalization plans, etc. and develop systems for monitoring the progress of those plans, etc. Furthermore, it is important that the development of various systems by each bank, etc. for managing risk and for managing conflicts of interest be verified, taking into account the size and characteristics of the bank, etc. in the course of inspections and supervision conducted by authorities.

ii) Acquisition and holding of voting rights in a company while being restructured

Voting rights related to shares in a company while being restructured are regarded as exceptions to the 5% rule only where they are held by a specialized investment subsidiary of a bank, etc. Furthermore, holding periods generally do not exceed ten years.[21]

Recently, an increasing number of companies have been unable to achieve business turnaround simply by changing terms and conditions or waiving debt. They need to restructure their business lines. In these cases, it may also be effective if a bank, etc. holds a certain number of shares and becomes actively involved in the business turnaround.[22] For this reason, it makes sense to permit a bank, etc. to hold the voting rights of a company while being restructured.

However, in this case, the requirements of the target company of which a bank, etc. directly holds voting rights need to be more restrictive than in cases where voting rights are held via specialized investment subsidiaries for ensuring the financial soundness of the bank, etc.

For this reason, it is appropriate to permit the voting rights of a company being restructured to be held for a ten-year period, even by a bank, etc. regardless of its shares in the company, for example, in cases where third-parties other than banks, etc. are involved, and where a business reconstruction plan which incorporates the equity investment of the bank, etc. has been formulated.

iii) Acquisition and holding of voting rights in a venture company

Voting rights related to shares in a venture company are regarded as exceptions to the 5% rule only where they are held by a specialized investment subsidiary of a bank, etc. Furthermore, the holding periods generally do not exceed ten years.[23]

Currently, a venture company is defined based on experiment and research expenses, etc., but given that it is difficult to apply such a standard to industries such as the service industry, it makes sense to expand the scope of the definition. Furthermore, in light of the actual conditions for venture funds, etc., such as the average period of fund management, it makes sense to extend the period for exception.

For this reason, it is appropriate to extend the exception period to 15 years as well as the expansion on the scope of venture companies that are exceptions to the 5% rule.

[21] Approval of the authorities is required in cases where the shares are to be held for a further one year or more.

[22] In addition to the bank, etc. that provided a loan to the said company, other banks, etc. could also take part.

[23] Approval of the authorities is required in cases where the shares are to be held for a further one year or more.

iv) Acquisition and holding of voting rights in a business company participating in revitalization of the entire region

In situations where the regional economy is sluggish, it is more important to revitalize a broad spectrum of enterprises in the region than just promotion of the revitalization for individual enterprises. On the other hand, there is a shortage of capital providers in regional areas. For this reason, it makes sense for banks, etc. to flexibly provide capital to such enterprises.

However, even in this case, due consideration should be given to ensuring the financial soundness of the bank, etc. For this reason, in addition to limiting the scope of the target company to a certain degree, it is important that the risk management of the bank, etc. be properly monitored through inspection and supervision conducted by the authorities.

For this reason, with regard to voting rights in a non-financial company participating in the revitalization of the entire regional economy (an enterprise which engages in business for the purpose of comprehensively revitalizing the sluggish regional economy, and which involves the integration and rebuilding of business), (i) in cases where the voting rights are acquired and held by a bank, etc., it is appropriate to limit the target to small and medium-sized enterprises, and to permit less than 15%[24] to be held for a period of ten years; and (ii) in cases where the voting rights are acquired and held via a specialized investment subsidiary, it is appropriate to permit less than 40%[25] to be held for a period of ten years.

v) Voting rights acquired and held as a consequence of business succession

As one of the options for a regional financial institution, etc. providing support for the business succession of a middle-sized or small to medium-sized company, it makes sense to allow a regional financial institution, etc. to hold shares in the company succeeding the business for a certain period of time. However, in holding those shares, due consideration should be given to ensuring the financial soundness of the bank, etc.

For this reason, with regard to voting rights acquired and held as a consequence of a middle-sized or small to medium-sized company succeeding the business, it is appropriate to permit voting rights in the succeeding company to be held for a five-year period regardless of the portion of voting rights, but only in cases where they are held through a specialized investment subsidiary.

vi) Voting rights acquired and held through a debt-equity swap

With regard to voting rights acquired and held by a bank, etc. as a consequence of a debt-equity swap, approval of the authorities is required in cases where the

[24] Less than 20% in cases where the enterprise is not included within the scope of consolidation on an influence basis when the equity method is applied.
[25] Less than 50% in cases where the enterprise is not included within the scope of consolidation on an effective control basis when the full consolidation method is applied.

holding period exceeds one year. However, in view of the fact that ordinary business reconstruction plans are scheduled between three to five years, this regulation is not consistent with business practice. For this reason, it is appropriate to extend the period exempt from the 5% rule to ten years.[26]

vii) Voting rights acquired and held in a trust account

Voting rights acquired and held by a trust bank in a trust account, which are exercised by the settlor or the beneficiary, are exempt from the 5% rule. In addition, voting rights acquired and held as an asset in a trust account without a contract clause for a trust bank's covering the trust principal, are also exempt from the 5% rule; but approval of the authorities is required in cases where the holding period exceeds one year.

In the case of voting rights acquired and held as an asset in a trust account without a contract clause for a trust bank's covering the trust principal, these are only acquired and held by the trust bank in a position of trustee, and do not impede the financial soundness of the bank, etc. For this reason, assuming that the trust bank exercises voting rights in favor of beneficiaries, it is appropriate to exempt from the 5% rule voting rights acquired and held as an asset in a trust account without a contract clause for a trust bank's covering the trust principal, regardless of the holding period.

(2) Foreign bank agency/intermediary services

(i) Basic concept

In cases where agency/intermediary services of a foreign bank are performed by domestic banks, they are not currently allowed to provide services on behalf of foreign banks that are not their parent/subsidiary or sister companies, in light of the necessity to ensure protection for the interests of customers in Japan, given that the direct supervision of Japanese authorities is not applicable to foreign banks.[27]

In this regard, there has been a request that domestic banks be allowed to provide financial products and services overseas on behalf of partner foreign banks with which they have no capital relationship so that Japanese SMEs operating overseas can raise funds more smoothly and obtain a variety of services.

In view of developing an environment where domestic banks support the overseas business expansion of domestic enterprises, it is important to broadly permit the agency/intermediary services of foreign banks. Furthermore, consistency with the objectives of current regulations to protect domestic customers could be

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26 In the Financial Inspection Manual, even if the duration of a management improvement plan is scheduled between five and ten years in cases where it is recognized that there has bee progress then the plan is adjudged to be reasonable.

27 These restrictions have been established because, assuming that the agency/intermediary services of a foreign bank could be performed without a capital relationship, the foreign bank could then conduct the same services as if it established a branch or local subsidiary in Japan irrespective of any capital relationship with a domestic bank.

ensured when domestic banks are permitted to provide agency/intermediary services overseas on behalf of a foreign bank.

For this reason, it is appropriate to allow domestic banks to provide the foreign bank agency/intermediary services, only when such services are conducted overseas regardless of whether there are capital relationships.[28]

(ii) Conditions for permitting agency/intermediary services of a foreign bank conducted overseas

i) Involvement of the authorities

Under current regulations, the agency/intermediary services on behalf of a foreign bank are, in principle, subject to approval by the authorities, but in cases where the foreign bank as a consignor has already obtained approval as a subsidiary company, etc. of a domestic bank, a notification system is applied. In cases where a domestic bank conducts the agency/intermediary services on behalf of a foreign bank with which it has no capital relationship, it is appropriate to obtain the approval of the authorities in order to secure an opportunity for the authorities to check the relationship, etc. between the domestic bank and the foreign bank.

ii) Form of entry into foreign markets

With regard to the form of entry adopted by domestic banks located overseas in providing agency/intermediary services, in view of the perspective described above, it is appropriate to allow agency/intermediary services to be provided in various forms, including the long-term assignment of bank employees, without stipulating such conditions as the establishment of overseas branches.[29]

iii) Scope of the agency/intermediary services

Under current regulations, the scope of agency/intermediary services provided by domestic banks is restricted to banking businesses and incidental banking businesses.

It is conceivable that services not permitted by Japan’s Banking Act are permitted as banking business overseas. However, domestic banks do not have sufficient know-how on these services, while it would not be viable for the Japanese authorities to adequately verify their appropriateness since they are conducted overseas. As a result, such services could impose a disadvantage on customers, and in turn, affect the soundness of the domestic bank’s management.

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[28] It is also appropriate to implement similar measures for cooperative financial institutions. Moreover, as part of developing an environment supporting the overseas business of Japanese small and medium-sized enterprises (SMEs), it is also appropriate to give consideration to measures that enable cooperative financial institutions to provide loans directly to the overseas subsidiaries of SMEs that qualify as their clients.

[29] However, it must be noted that overseas (local) regulations may be imposed on the Japanese bank, such as an obligation to establish a business base overseas.

For this reason, it is appropriate to restrict the scope of agency/intermediary services provided, as before, to the banking businesses and incidental banking businesses set forth in the Banking Act.

(3) Regulations on the scope of subsidiary business in relation to overseas M&A

Currently, the scope of a bank' subsidiaries (including second-tier subsidiaries), is limited to certain entities (hereinafter "eligible subsidiary company"), such as banks, insurance companies and foreign companies that engage in banking business.

With respect to this point, it is pointed out that when a domestic bank and a foreign bank compete to acquire another foreign financial institution, the former is put in a disadvantageous condition, as it is essentially required to state in terms and conditions of the bid that it will sell the target financial institution's subsidiary companies that are not allowed to be an eligible subsidiary company under the Japanese rule; this hinders the overseas business expansion of domestic banks.

In light of the importance of developing an environment that facilitates the international expansion of banking groups, while basically maintaining the current regulations on the scope of business, it is appropriate to permit domestic banks, etc. to hold companies that are not eligible subsidiary companies, for a certain period of time, only in cases where they acquire an overseas financial institution, etc.[30,31]

In cases where a domestic bank, etc. is permitted to hold a company that is not an eligible subsidiary company, it is appropriate to limit that holding period, in principle, up to five years.[32] Furthermore, with regard to the scope of acquired financial institutions, etc., it is appropriate to also permit acquisitions of insurance companies and securities companies, etc. as well as foreign banks.

<u>Conclusion</u>

Abovementioned are the findings from the deliberations at the Working Group. The point at issue in these deliberations has been that, from both the perspective of the need for a response to international trends and the viewpoint of further strengthening the functions of Japanese financial institutions, a rapid response is needed. In light of the approach presented in this report, it is hoped that the relevant organizations will proceed promptly with the appropriate development of systems.

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30 It is also appropriate to implement similar measures in cases where a bank holding company makes the acquisition. Furthermore, it is also appropriate to implement similar measures for the Shinkin Central Bank, etc., which may make overseas financial institutions its subsidiaries.

31 With regard to regulations on the scope of a subsidiary's business in relation to the acquisition, etc. of foreign insurance companies by Japanese insurance companies, these were revised by the March 2012 amendment of the Insurance Business Act. In principle, companies ineligible to be subsidiary companies but recognized as already being held at the time of acquisition are permitted to be held generally for five years.

32 In cases where disposal of the company within five years has become difficult due to deterioration of local market conditions, etc., or where it is recognized that there is a need to continue holding the company that is ineligible to be a subsidiary company due to local competitiveness, it is appropriate to permit an extension of the holding period with approval by the authorities.