
Bank Sector Reforms To Allow Participation of Non-Financial Firms

Shinichi Imura

On 29 May 2000 the Financial Supervisory Agency in conjunction with the Ministry of Finance published planned revisions to the Banking Law, followed on 30 May by the publishing by the Financial Supervisory Agency and the Financial Reconstruction Commission of operational guidelines for the licensing and supervision of non-financial entities entering the banking sector. This report will examine a prior government report on the financial services sector, the development of online financial service provision and its supervision that formed the basis of the above draft legal revisions, and will consider outstanding issues with regard to both the draft revisions and operational guidelines.

1. “Development Of Online Provision Of Financial Services And Its Regulatory Supervision”

Forming the basis of the planned revisions to Japan’s Banking Law and the introduction of a licensing and supervision system for non-financials entering the banking sector, the Financial Supervisory Agency’s “Online Financial Services Regulatory Supervision Study Group” published on 18 April 2000 a report entitled “The Development Of Online Financial Service Provision And Its Regulatory Supervision.” In this section we will outline the purpose and findings of this report.

1) Purpose

The FSA's study group met ten times from September 1999 onwards in order to discuss measures to cope with the spread of internet financial services and the major changes that would likely result in the financial services industry and markets. Its primary aim was to smooth the course of development of financial e-commerce by updating the legislative system and related supervisory regulations, and by ensuring adequate customer protection.

The study group’s main considerations were to: (1) promote the development and leverage the particular strengths of e-commerce in financial services; (2) to ensure the protection of users given the particular characteristics of e-commerce; (3) take into account international developments; (4) to consider a supervisory system not just in terms of the financial sector alone, but also its compatibility with other industry sectors.

2) Findings

The report’s findings were grouped into eight main themes: (1) provision of documentation to customers in digital form; (2) information disclosure in digital form; (3) provision of explanatory information when conducting sales or soliciting for business; (4) troubleshooting procedures; (5) cross-border transactions; (6) involvement of third parties; (7) new IT technologies and the financial services industry; (8) branch / sales offices and their computerization. Under these areas it brought together a number of useful proposals regarding regulatory supervision of online financial services and regarding the current state of the financial services industry (Table 1).

Table 1 Priority Considerations

<p>(1) Provision of documentation to customers in digital form</p> <ul style="list-style-type: none">● The fact that e-commerce does not need to rely on paper-based communications is a major advantage. Current industry legislation assumes that documents will be delivered in paper form, so lawmakers should consider how to allow digital media as an alternative.● In order for an electronic medium to be acceptable as a replacement for paper-based delivery, the group proposed the following requirements: (1) blanket permission from customers and confirmation of method of saving data should be obtained; (2) need for clear information regarding non-digital delivery media; (3) establish methods of confirming the customer has received the documentation
<p>(2) Information disclosure in digital form</p> <ul style="list-style-type: none">● Financial service providers should be obliged to provide information online to customers trading on the internet at the same time as it is available in paper form. The report further noted that digital media have unique advantages in terms of constant accessibility and timely disclosure.● In order to ensure that disclosure via digital media is full and thorough, due attention should to be paid to: (1) layout and clarity; (2) timing and frequency of information provision, and fullness of content.● Though both market institutions and industry participants are currently working towards the digitalization of information disclosure, the advent of online financial services provision means that companies will have to ensure full and comprehensive disclosure via digital media if they are offering such services, while online banks and other purely internet-based financial services providers should be made exempt from current legal requirements to disclose information in paper form and digital disclosure alone be permitted.

(3) Provision of explanatory information when conducting sales or soliciting for business

- The necessity to protect the rights of users of online financial services is no different than that of other business services, and so the duty to provide explanation as defined in financial industry law should be equally applicable.
- Since explanatory information will be delivered in digital format and not face to face, companies need to take adequate steps to ensure that the customer has been fully informed by confirming receipt of e.g. e-mails containing explanation, and offer customers the chance to ask questions. This will also contribute to the greater use of online financial services as customers will feel a greater sense of security.
- Effective digital methods of confirming the identity of customers must be used in order to prevent money-laundering or other such activities.

(4) Troubleshooting procedures

- As a prerequisite for the growth of online financial services in Japan each financial services company needs to have in place proper procedures for preventing and dealing with any problems that may arise. Financial services companies will also have to inform users in advance of responsibilities and contact procedures in such events.
- In order that a wide number of users can benefit from online financial services based on full knowledge of how it is conducted, companies will not only have to give full information regarding the use of those services, but should also fully inform users of the risks involved and the contact procedures to be followed in case of any problems arising. The website of the supervisory authorities can also play a useful role in this regard.

(5) Cross-border transactions

- Where financial service providers based overseas offer services to domestic Japanese customers, they need to ensure that adequate information regarding their services is provided. Therefore their websites should disclose to their customers such information as the domicile of the service provider and country / region in which it is licensed.
- The website of the relevant regulatory authorities should also contain information pertinent to the use of cross-border services. They also need to consider how to inform overseas service providers of the criteria by which their actions may be in conflict with Japanese regulations.
- Japan's regulatory authorities must also actively participate in the framing of international standards for governing online financial services and work towards harmonizing domestic regulations with those standards.

(6) Involvement of third parties

- Since online financial transactions are conducted via an Internet Service Provider, financial service providers need to set out adequate measures to limit risk and provide their customers with a full explanation of these risks. The regulatory authorities should check that these measures are in place and explanations available as part of their supervisory duties.
- An increasingly common practice is for financial service providers to outsource the IT systems work involved with their service. However the service providers should be fully aware that this in no way lessens their fiduciary responsibilities to the customer. Regulatory authorities also need to consider how to develop effective monitoring procedures to assess the outsourcing risk management policies of service providers.

(7) New IT technologies and the financial services industry

- Online financial service providers need to ensure that links on their websites are not misleading to customers. Further, the provision of a wide range of additional information on a website is not infringing the prohibition on engaging in other types of business as long as the scope of involvement in these other activities is limited to the non-commercial provision of information.
- The internet has opened the way to new types of financial service provision through its use of hyperlinks and searches. Legislation also therefore needs to take into account the likely emergence of new types of financial products, sales channels and service providers beyond that envisaged within the current legal framework.

(8) Branch / sales offices and their computerization

- The rapid spread of online financial services means that now companies no longer require any physical customer-facing branch presence. If adequate rules and procedures are in place it should be possible for the role that these branches played in the provision of traditional services to be carried out in other ways.
- Accordingly when granting licenses or registering companies to provide online financial services, service providers should not be assessed simply on whether the function of branch offices is being replicated but by taking the service as a whole into consideration. The greater use of telephone centers is also changing the way in which branch-like services can be provided. Therefore the current regulations in which physical branch offices are viewed as central to the provision of financial services need to be revised.

Source : NRI, from "The Development of E-Commerce In Financial Services And Its Supervision"

2. Revisions To The Banking Law¹

On 29 May the FSA and Ministry of Finance announced planned revisions to the Banking Law to deal with the proliferation of sales channels afforded by the use of the internet. The entire bill seemed to be based on the above report by the FSA's study group.

1) Background To The Bill And Principal Contents

Regarding the provision of financial services over the internet, the bill set out the following necessary conditions: (1) announcement of main deposit rates and fees payable by depositors (Article 13-3); (2) measures to prevent customers confusing money claims and similar instruments with deposits (Article 13-5); (3) measures to prevent customers believing services offered by other companies linked to from the service provider's website are provided by the service provider itself (Article 13-6-2; new provision); (4) internal company regulations regarding explanation of services to customers (Article 13-7).

Table 2 Draft Revisions To The Banking Law

Article	Before revision	After revision
Provision of information to depositors (Article 13-3)	1. Principal deposit rates etc. to <u>be on display in branch offices</u> 2. <u>Display or availability of a table of commissions in sales offices (or deposit fees payable in unmanned offices)</u>	1. <u>Display</u> of principal deposit rates etc. 2. <u>Display of fees payable for deposit handling</u>
Prevention of customer misunderstanding financial products as money claims, deposits etc. (Article 13-5)	In the handling of [certain] products, banks must provide written or other explanatory materials to customers so as to prevent confusion with deposit type products in accordance with the experience, knowledge and asset position of the customer.	In the handling of [certain] products, banks must provide <u>in accordance with the manner in which they conduct business</u> written or other explanatory materials to customers so as to prevent confusion with deposit type products in accordance with the experience, knowledge and asset position of the customer.
<u>Measures to prevent confusion of bank with other party</u> (Article 13-6-2)	None	<u>Banks using electronic communications and information processing hardware to deliver services must adopt appropriate measures to prevent customers mistaking the bank itself for other service providers</u>
Company internal regulations (Article 13-7)	Banks must draw up internal regulations to ensure adequate explanation regarding the contents of their business is given to customers in accordance with their experience, knowledge and asset position, plus adequate explanation of any other information that would be considered important and right and proper that the customer should be informed, and in order to ensure that the business is conducted in a fair and proper manner. Banks must also ensure that measures necessary to ensure compliance with these internal regulations including training of employees are in place.	Banks must draw up internal regulations to ensure adequate explanation is given regarding the contents <u>and manner of</u> their business to customers in accordance with their experience, knowledge and asset position, adequate explanation of any other information that would be considered important and right and proper that the customer should be informed, and in order to ensure that the business is conducted in a fair and proper manner. Banks must also ensure that measures necessary to ensure compliance with these internal regulations including training of employees are in place.

Source: NRI, from materials supplied by the Financial Supervisory Agency

1 Public comments were invited up to 16 June 2000.

Regarding the availability of deposit rate and fee tables, the revised legislation removes the words referring to where exactly (e.g. branch office) this information must be displayed in order to allow the online provision of this information and further facilitate the use of various other sales channels such as the internet. This has been prompted by the concept of “disclosure via digital media” as mentioned in Table 1.

The second revision adds the words “manner of business” in order to introduce a more flexible interpretation to the clause to encompass online information provision. This is prompted by the concept of “provision of documentation to customers in digital form” as mentioned in Table 1.

The third item regards measures to prevent mistaking the bank for other parties. This has been added as customers may easily follow links from the bank’s site to providers of other services without realizing that the providers of these other services are not the bank itself. This would seem to be following on from points 7 and 8 in Table 1 regarding new IT technologies and the financial services industry, and branch / sales offices and their computerization.

The fourth revision, concerning providing explanations to customers, adds the words “and manner of” (the bank’s business) in order to ensure that the bank also gives an adequate explanation regarding the manner (e.g. via the internet) in which the business is carried out.

2) Effectiveness

After being open to public comments up to 16 June 2000, the revised bill is set to go into effect from 1 October.

3. New Operational Guidelines Regarding Bank Licensing And Regulatory Supervision

Work towards a new legislative infrastructure to accommodate the peculiarities of conducting business over the internet has been provoked by the plans of non-financial companies Ito-Yokado and Sony to set up a specialist settlements bank and an internet bank respectively. On 30 May 2000 the FRC and FSA together drafted a set of operational guidelines for a new system of licensing and regulating such non-financial firms entering the banking industry.

1) Main Points In The Operational Guidelines²

The operational guidelines concentrated on the following 5 main points:

- (1) Ensuring the independence of a banking subsidiary from its parent

2 The guidelines were to be open to public comment up to 30 June 2000, after which the Banking Law revisions would go into effect.

- (2) Insulation of banking subsidiary from business risk of parent
- (3) Controls to protect private customer data, particularly when operating joint business initiatives
- (4) Ensuring adequate profitability of the bank and risk management procedures particularly where the bank holds a large amount of its assets in marketable securities (even if these are government bonds)
- (5) Customer protection where banks have no physical presence and rely solely on the internet and ATMs

Table 3 details these 5 points, the agencies' basic approach to each issue and how they plan to deal with these in revised licensing and supervisory procedures.

Table 3 Overview Of The Operational Guidelines

		Issue	(1) Basic approach	(2) Licensing / Regulatory Supervision Checkpoints	
				a. Licensing	b. Post-licensing Supervision
II. Main points regarding new types of banking business / entities	(1)	Ensuring the independence of a banking subsidiary from its parent	The independence of the bank needs to be maintained in order to ensure its viability. If any single company owns over a 20% voting interest in the bank and can therefore exercise significant influence over management decisions then the independent action of the bank needs to be particularly carefully monitored.	a) If controlled by a non-financial company or parent, then their business strategy and the role of the banking subsidiary needs to be examined. b) Check for example whether banking subsidiary and non-financial parent share any directors. c) Check if banking subsidiary and parent share same employees	As a condition of continuing to maintain a license, the non-financial parent company must inform the authorities regulating the banking subsidiary of any major change in its shareholdership. Independence of subsidiary management to be ensured by inspections and reports.
	(2)	Insulation of banking subsidiary from business risk of parent	Even if the management of the subsidiary is independent, there is still a possibility of the subsidiary being exposed to parent company risk. Especially if the subsidiary and parent have shared business interests then there is a risk that a collapse of the parent will also bring down the subsidiary.	(1) Support or financing of parent company not allowed; (2) Due consideration to the risk of deposit outflow and fall in share price on rumours of poor parent performance; (3) That continuation of business is not at risk where parent / subsidiary have shared business interests. Further, parent financials and business condition need to be assessed.	a) Inspection of subsidiary and subsidiary reporting. The subsidiary may also be subject to business improvement orders under Article 26 of the Banking Law. b) Subsidiary will have to regularly submit its parent's financial statements as a condition of keeping its license.

	(3)	Customer data privacy in case of joint business initiatives	Though likely that some customer information will be passed between parent and banking subsidiary, need to confirm that controls are in place to maintain personal information as private. If a Private Data Protection Act is passed, then this would be an infringement.	Confirm that adequate controls are in place to protect private customer data. If customer data is to be shared, confirm that customer's consent if received first.	After granting of license confirm that the banking subsidiary is complying with private customer data protection policies through inspections and reporting.
	(4)	Ensure profitability and risk management procedures if large proportion of assets held in marketable securities	Considering that such businesses are different from traditional banks, even if a large proportion of assets are held in the form of marketable securities such as sovereign debt, the company needs to be assured of an adequate capital base according to its interest rate risk and operational risk profile	a) Check if equity capital is reasonable considering interest rate and operational risk profile, and whether using ALM or other risk management system. b) Assess source of earnings and stability c) If specialist settlement bank then confirm that settlement operations are competent	Check that level of capital required when license granted is being maintained, and proper risk management procedures are being followed by inspections and reporting. Also confirm that sources of earnings are same as identified when license granted.
	(5)	Customer protection when there are no staffed offices and bank-customer contact is limited to internet and ATMs	Regulations and related supervision rules need to be revised to take internet based trading into account. Revisions will be based on the recommendations contained in the report of the Online Financial Services Regulatory Supervision Study Group.	a) (1) Customer complaints procedures; (2) Customer handling in case of system etc. failures; (3) Customers are being provided with adequate explanatory materials; (4) Proper disclosure being performed; (5) Proper procedures for confirming customer identity to prevent money-laundering and other such illegal activities are in place b) Assess earnings forecasts c) Measures to ensure adequate liquidity are in place d) Security of computer systems	Inspections and reporting to be used to ensure the company is properly performing the various procedures checked at the licensing stage
II. Application to existing banks	-	The points regarding regulatory supervision set out in section I. above will basically apply in the same form to existing banks if purchased by a non-financial company, if planning on using customer private information or if setting up an internet banking operation. Points regarding licensing and regulatory supervision (1) to (3) will also be applicable where a non-financial company owns a bank holding company.			

Source: NRI, from materials supplied by the Financial Reconstruction Commission and Financial Supervisory Agency

Point (1) of the operational guidelines makes any shareholder with a 20% or more interest in a banking subsidiary subject to regulatory supervision, as such a shareholder would have the potential to significantly influence the management of the bank. This is based on the assumption that guaranteeing the management independence of a banking subsidiary is a very important part of guaranteeing its viability as a business concern.

The second point concerns itself with insulating a banking subsidiary from the business risk of its parent, and specifically prohibits the use of the banking subsidiary to supply funds to a distressed parent. In order to ensure this the parent company must submit financial statements to the authorities after receiving a license to run a banking subsidiary.

The third point regards both pre- and post-licensing checks on internal regulations and procedures governing the use of private customer information. It assumes that the proper conduct of a bank is to protect the privacy of customer information but recognises that information may be passed between banking subsidiary and non-bank parent.

The fourth point concerns the need for checking on risk management procedures and earnings profiles in the case of specialist settlement banks.

The fifth point, concerned with specialist internet banks, regards the checking of procedures for customer liaison, IT systems, disclosure and company profitability. Further, regarding the overall application of rules and regulatory supervision to online financial services it points out that legislative revisions should be based on the findings of the report into “Online Financial Service Provision And Its Regulatory Supervision.”

The main focus of the operational guidelines has therefore been on preventing banking subsidiaries being set up to funnel funds to their non-financial parents, and on ensuring that specialist settlement or internet banks are able to actually make a profit. In terms of its recommendations for modifying the way in which regulatory supervision of financial firms is carried out, these operational guidelines have clearly been extensively influenced by the “Online Financial Service Provision And Its Regulatory Supervision” report and the subsequent planned revisions to the Banking Law.

2) Further Issues To Be Taken Up By The Financial System Council

The operational guidelines also called for urgent examination by the Financial System Council of the following points ahead of the framing of legislation:

- (1) Under current Japanese legislation the regulatory authorities have no right to be informed in advance of any change in share ownership in order to prevent any unsuitable party from becoming a shareholder and damaging the viability of the bank. Based on the recommendations contained in the Basle Committee Core Principles for Effective Banking Supervision and the systems in place in other advanced industrial nations, the FSC should consider the legislation of such rights.
- (2) The guidelines also call for the FSC to consider various reforms to the prohibition on banks engaging in other business activities along the lines of the revised 3-year plan for deregulation approved by the cabinet in March 2000, this being the obverse of allowing non-financial entrants into the banking sector.

4. Overall Evaluation And Remaining Issues

We welcome the steps the Financial Supervisory Agency has taken towards deregulation in that it has clearly come out in favour of encouraging competition in the banking sector. It has recognized the need to review the current system of rules and regulatory supervision in the light of the peculiar requirements of internet based businesses through its report “The Development Of Online Financial Service Provision And Its Regulatory Supervision.” Based on this report it has planned legislative revisions to the Banking Law, and opened the way for non-financial companies to enter into the banking sector and form new types of banking entities through its operational guidelines for licensing and supervision of these new types of banks.

However many issues remain to be tackled. As mentioned above, the Financial System Council will be deliberating two important questions: whether the financial regulatory authorities should be given the power to prevent what it deems to be unsuitable shareholders from holding an interest in a banking operation, and whether it should promote deregulation of banks being engaged in non-banking related business. However the significance of the current legislative reforms also need to be considered from a much wider perspective.

Firstly, is the object of regulatory supervision to be the financial institution itself or its financial function? With advances in IT and financial engineering, and the proliferation in different types of financial products and services, the entity handling those products and services is becoming more and more vague, and as a result increasing the chance of regulations becoming more out of touch with business realities. An inevitable consequence of framing legislation based on a model of “traditional” financial institutions is that, as different types of financial institutions come into being, those regulations then become complicated and inefficient and increase the burden on regulatory authorities to exercise more discretion in the application of those rules.

Thus there would be many advantages to be gained by regulating the financial “function” (the specific acts of business that affect the financial system) rather than the institution, regardless of the form the institution takes. This approach may also have its own difficulties, however. Financial crises for example tend to originate in problems with the institution rather than with its performance of the financial function, and so there is definitely a case for also regulating financial institutions in the traditional way.

In order to ensure transparency in financial regulation there needs to be detailed consideration of such issues as the disclosure of the reasons behind licensing and other decisions. Such debate however needs to be framed in terms of how best Japan can develop its financial services industry.

A second wider concern is how to improve the inspection and regulatory supervision system. While the operational guidelines were limited to checkpoints to be followed during pre-licensing inspection and post-licensing supervision, the question here is how these guidelines will be implemented in terms of banking law and operational procedures. In this case the conditions for obtaining a license ought to form the basis of the subsequent regulatory supervision while eliminating as far as is possible all “discretion” from the decision-making process and making it as fair as possible.

The conditions which the UK regulatory authorities, which allowed the entry of non-financials to the banking business much earlier than Japan, have stipulated for granting licenses to non-financial firms are perhaps instructive, namely: (1) that banking business is conducted in a prudent fashion, as conditions of which equity capital requirements, regulations on credit exposure, liquidity, reserves and provisions, organization of IT systems and internal management, and the character and abilities of directors and management are taken into account; (2) that a company has sufficient expertise and skill to carry out banking business (integrity and skill); (3) that management and directors are "fit and proper." The third point in particular, requiring that the financial regulatory authorities assess whether management and directors of a company are "fit and proper," is particularly worthy of note.

Japan does have something roughly equivalent to this "fit and proper" rule in Article 4-2-2 of the Banking Law. It may be important to see how far this rule is applied in future as a way to ensuring the proper governance of banking entities by directors of Japanese companies.

Thirdly, how far should Japan go in allowing banks to conduct non-banking activities, as is prohibited under Article 12 of the Banking Law? In the case of the US the role of banks and other types of businesses are kept clearly separate in law. However debate on this point is not easy due to the apparent unfairness of allowing participation in one direction and not the other. In Japan's case it would however appear that there is little incentive for banks to start operating in other business sectors. Bearing in mind that this also seems problematic for other countries, in our view Japan should proceed with caution regarding the extent and timing of deregulation, taking the views being expressed in the US also into account.

The banking industry in Japan is now having to undergo a period of change. Banks unable, in the face of competition from the non-financial sector, to embrace internet technologies and continually innovate are unlikely to be able to survive. Key focus points in this scenario are the development of the debate on deregulation, and how individual financial institutions can reform their business strategies.