Financial regulation

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Overview

The Ministry of Finance, or Zaimusho, regulates development banks and other government financial institutions, and oversees international inflows and outflows of capital. It also exercises jurisdiction over economic management and fiscal affairs, including setting and collecting taxes, issuing government bonds, and formulating the national budget.

The Financial Services Agency (FSA) supervises, inspects and monitors financial institutions. The FSA also has the power to manage failing institutions and protect investors and depositors. (The finance ministry is involved in decisions that may call for fiscal action, such as the infusion of public funds.) The finance ministry and the FSA have the power to write or amend laws and regulations covering their respective areas of jurisdiction.

The Bank of Japan (BOJ, the central bank) is not part of the government, but remains a semi-governmental corporation. The BOJ is capitalised at ¥100m (US$900,000) and 55% of its equity is owned by the finance ministry. The rest of its shares are held by corporations and private individuals that have no say in the running of the central bank. The BOJ publishes financial results and pays income tax.

The BOJ is the sole issuer of bank notes, the bank of the government and a lender of last resort to commercial banks. Its primary concerns are controlling inflation, managing the money supply and maintaining stability in foreign-exchange markets, all of which it deems critical for stable economic growth. The central bank intervenes almost daily in money markets, buying and selling government securities or making and recalling loans to banks in order to influence overnight call rates via supply and demand. Although only the overnight rate is directly affected, other rates move based on the markets' perceptions of the BOJ's prevailing interest-rate policy.

Bank supervision. Introduced in 1998 the prompt corrective action (PCA) programme allows the authorities to take pre-emptive steps to prevent banks and other financial institutions from failing. When a financial institution's capital adequacy ratio falls below a certain level, the authorities can order it to file and implement a management reform plan.

The PCA system is designed as an early-warning mechanism for financial institutions by obliging them to conduct a stricter assessment of customers' loans and carry out more aggressive debt write-offs. This represents the formal adoption of international capital-adequacy standards set by the BIS. Banks that operate internationally are deemed adequately capitalised only if their BIS ratio (net worth divided by risk-weighted assets) is at least 8%. Banks that operate only domestically must have a ratio of at least 4%. The required total capital ratio under the new Basel III international capital-adequacy rules remains at 8%, but the tier-1 capital ratio has risen from 4% to 6%. These new requirements are to be implemented by banks worldwide by 2019. (Tier-1 capital refers to the ratio of a bank's core equity capital to its total risk-weighted assets.)

Banks must assess the quality of their assets based on four credit categories: class one, representing healthy loans; class two, loans that require "special attention" because the creditworthiness of borrowers raises concerns; class three, loans whose recovery looks "doubtful"; and class four, unrecoverable loans to bankrupt borrowers. Banks are also required to disclose "risk-manage-ment" loans (a category that includes loans that have not been serviced for three months or longer) and restructured loans (loans in classes two, three and four combined). At the same time, financial institutions are asked to write off or make provision against up to 70% of class-three loans and 15% of class-two loans that are not secured by collateral. The writing-off of two or three times actual lending losses is required for the remainder of class-two loans.

The PCA programme is the toughest regulatory requirement that the FSA can apply to banks that fail to meet prescribed BIS ratios. The intensity of a PCA programme grows incrementally with the degree of capital depletion at a troubled bank, starting with a request for the bank's turnaround plan and culminating with a suspension of part or all of its operations. A bank put under a PCA programme is given one year to shore up its capital base. Major banks face government inspections of their books annually, while insurance companies are subject to FSA inspection once every 18 months. Meanwhile, the FSA is widening the scope of unscheduled inspections of financial institutions and conducting spot checks even on healthy institutions.

The FSA enforces restrictions on large exposures by banks and insurance companies. Japanese banks are required to cap their credit exposure (including loans, guarantees, equities, corporate bonds, commercial paper and derivatives) to an individual borrower at 25% of their equity capital, while exposure to conglomerates is subject to a ceiling of 40%. The same caps apply to insurance companies.

The FSA also regulates financial services providers' sales pitches to clients, under the Law on the Sale of Financial Products. The law, which is intended to protect investors' interests, requires providers to explain to customers fully all the risks associated with a product prior to a sale. It also gives investors the right to file claims for damages in connection with their investments in a wide range of financial instruments.

The Deposit Insurance Corp of Japan (DICJ), a bank bail-out agency funded by public and private contributions, plays a pivotal role in the Japanese financial system. The DICJ's main function is to finance bank bail-outs and prevent bank runs by acting as a central bank for troubled banks. It uses cash subsidies, loans and loan guarantees, asset and bond purchases, share subscriptions, and other financing facilities to help healthy financial institutions to absorb the operations of failed banks. It also offers protection to depositors and administers rehabilitation or liquidation measures for failed institutions. The DICJ's operations cover all commercial banks (excluding foreign bank branches), credit associations and credit co-operatives.

During a bank failure, the DICJ provides insurance coverage up to a maximum of ¥10m and interest accrued on time deposits, standard savings accounts and demand deposits. Assets deposited at Japanese branches of foreign banks and overseas branches of Japanese banks are not covered.

The DICJ is authorised to set up a "bridge bank" to deal with a bank failure when no buyer of a failed financial institution comes forward. The operations of a bridge bank should be completed within two years, extendable to three years. It is charged with temporarily handling the deposits and loans of a failed bank until a private company takes over its operations.

Regulatory watchlist

Legislation was passed in May to recognise and regulate virtual currencies, like bitcoin, that have a "function similar to real money". The legalisation of virtual currencies has been on the cards since the collapse of Mt Gox, a bitcoin exchange based in the capital, Tokyo, in February 2014. The FSA will require virtual currency exchanges to register with it and be subject to its supervision and oversight. In July the Bank of Tokyo-Mitsubishi UFJ (BTMU), the banking unit of Mitsubishi UFJ Financial Group, announced an alliance with US bitcoin exchange operator, Coinbase, and plans to launch its own virtual currency in 2017.

The new legislation also revises Japan's Banking Law so that banks and bank holding companies can acquire bigger stakes in non-banks, subject to FSA consent. Previously, banks were restricted to owning no more than 5% of non-banks, and bank holding companies no more than 15%. This will allow banks and bank holding companies to invest more in information technology (IT)-related firms in order to develop the "fintech" sector. In August a joint venture between Japan's SBI Holdings and the US fintech company, Ripple, announced the creation of a consortium of 15 Japanese banks to build a platform using blockchain technology for instant national and international payments, with a possible launch date in 2017. Watch for the expansion of other fintech start-ups, such as bitFlyer and Freee, which will be able to raise capital more easily.

In February 2014 the FSA published its new stewardship code for institutional investors, which is designed to promote the sustainable growth of companies through investment and dialogue. It is part of the government's strategy to enhance the country's corporate governance and improve investment returns. Participating institutions should monitor firms that they invest in, encourage them to improve their management, publish guidelines on how this can be done and disclose how they exercise their voting rights. This voluntary code is proving popular with the industry, and by early September a total of 213 asset managers had signed up to it.