Unofficial and Provisional Translation
Readers are advised to refer to the original Japanese text before quoting from this document.

Financial Reconstruction Commission
Financial Services Agency
August 3, 2000

Measures for Licensing for and Supervision of New Types of Banks including Entry into Banking Business by Non-Financial Entities (Operational Guidelines)

I. Principal Issues of New Types of Banks and Measures for Licensing and Supervision

1. Maintaining the independence of a subsidiary bank from its non-financial parent entities

(1) Basic principles

Ensuring management independence is a prerequisite for ensuring sound bank management. In certain instances, non-financial entities are included as principal shareholders which may presumably exert a material impact on the management policies of the bank. (Note) In such cases, special attention must be paid to ensuring the independent management of the bank so that the soundness of the bank may not be undermined at the request of business strategies by the non-financial entities (hereinafter referred to as the “non-financial parent entities”).

(Note) In accordance with the standards of affiliation based on the effective influence standards in corporate accounting, a principal shareholder which may presumably exert a material impact on the management policies of the bank shall, in principle, be defined as any shareholder with 20% or more of the voting rights on its own account. Specifically, this shall include domestic corporations which owns banks as subsidiaries or affiliates under corporate accounting principles, and foreign corporations holding 20% or more of the voting rights of a bank on their own account.

Substantive investors of investment groups, who hold 20% or more of the voting rights of a bank on their own account, shall be included.

(2) Matters to be considered in licensing and on-going supervision

a. Matters to be reviewed in the process of licensing

i) The existence of non-financial parent entities shall be reviewed. When non-financial parent entities do exist, their profile and the position of their subsidiary bank in their business strategies shall be reviewed.

ii) It shall be reviewed whether the management system exists ensuring independent decision-making by bank management motivated at all times by giving priority to achieving sound bank management.

For instance, it shall be reviewed whether or not independent management of the subsidiary bank is being undermined by the fact that its directors simultaneously serve on the board of directors of its non-financial parent entities.

iii) In cases where the subsidiary bank shares the branches and offices of its non-financial parent entities, it shall be reviewed whether or not sound and appropriate management of the subsidiary bank is being undermined in terms of security or risk management, arising from the fact that certain banking operations have been consigned to its non-financial parent entities, or from the fact that employees of its non-financial parent entities serve as bank personnel as well.

(This criterion shall be generally applied to banks operating "in-store branch" [banking operations located within retail stores], including the installment of ATMs in convenience stores.)

b. Matters to be considered in on-going supervision

i) After licensing, a subsidiary bank shall be required to submit a prompt report to the supervisory authority if any changes take place in principal shareholders which fall under the category of "non-financial parent entities." (This shall be pre-condition for licensing.)

ii) After licensing, such matters as management independence of a subsidiary bank and the maintenance of sound and appropriate banking operations shall be reviewed through inspection of the subsidiary bank or through submission of reports.

2. Shielding the subsidiary bank from operational risks of its non-financial parent entities

(1) Basic Principles

Even if management independence of a subsidiary bank is properly ensured, the subsidiary bank may be affected by a deterioration in the business conditions of its non-financial parent entities or other risk factors pertaining to its non-financial parent entities which are beyond the control of the subsidiary bank. This is especially true where the subsidiary bank and its non-financial parent entities share the same operational base. In such instances, the financial failure of the non-financial parent entities may all at once undermine the operational base of its subsidiary bank (the risk of going under together). To cope with such risks, current restrictions on large credit exposure and arms-length rules (prohibition of preferential treatment of affiliated parties) must obviously be rigorously observed. In addition, the following matters shall be taken into consideration.

(2) Matters to be considered in licensing and on-going supervision

a. Matters to be reviewed in the process of licensing

i) It shall be reviewed whether adequate measures (see note) have been taken by the subsidiary bank to isolate itself from the operational risks of its non-financial parent entities. These measures shall, at the minimum, include the followings:

[1] The subsidiary bank shall not provide support, credit and so on, to its non-financial parent entities, in case of the deterioration of financial conditions of the non-financial parent entities.

[2] Various risks shall be assumed arising from the deterioration of financial conditions of the non-financial parent entities, sales of shares of the subsidiary bank by its non-financial parent entities, and withdrawal of deposits. They include drop in share prices, outflow of deposits and loss of customer base resulting from the extinction of synergy effects and reputational risks. The subsidiary bank shall take measures, including ensuring sources of revenues and funding, and increasing equity capital, to ensure the sound bank management thereby.

[3] Particularly in cases where the subsidiary bank and the non-financial parent entities share the operational base, measures shall be taken so that the failure of the non-financial parent entities does not jeopardize the continuation of banking operations.

(Note) As for subsidiaries, other than the subsidiary bank, of the non-financial parent entities, in some instances it is highly probable that the risks of subsidiaries spread to the subsidiary bank when the subsidiaries and subsidiary banks share the operational base. It shall be reviewed, therefore, that risk-shielding measures necessary to prevent the spread of risks from the subsidiaries to the subsidiary bank are taken.

ii) Notwithstanding the above risk-shielding measures, complete shielding from risks pertaining to the non-financial parent entities may be difficult to achieve. Therefore, the business conditions of the parent non-financial entities which may affect the management of the subsidiary bank shall be reviewed in order to identify, at an early stage, the deterioration of financial conditions of the subsidiary bank resulting from management risks pertaining to the non-financial parent entities.

Specifically, in the process of reviewing the income projections and public confidence in the applicant for bank license, the financial conditions of and public confidence in the non-financial parent entities shall also be fully considered. As part of the licensing process, the applicant shall be required to submit the financial statements and auditor's report of the non-financial parent entities for the latest settlement period [Note 1] together with the report [Note 2] prepared by a second auditing firm certifying that the auditor's report is appropriate. (If the non-financial parent entities are a foreign company, the applicant will be required to submit similar materials indicating the financial conditions of the non-financial parent entities.)

[Note 1] Together with the auditor's report, the subsidiary bank shall be required to submit an opinion of auditors averring that no notable problems exist which jeopardize the ability of the non-financial parent entities to continue operations as a going concern.

[Note 2] The provisions of Article 9-4 in the Ordinance of the Ministry of Finance on Disclosure of Corporate Affairs permit corporations acquiring a certain minimum rating to submit simple-form registration statements. In the case of such corporations, the requirement concerning the submission of a report by a second auditing firm certifying the contents of the auditor's report may be waived.

[Note 3] The examination of risk-shielding measures mentioned in this section shall generally be deemed unnecessary, if the non-financial parent entities are private individuals that do not run businesses. Even in such cases, however, reviews including the examination of public confidence shall be required.

b. Matters to be considered in on-going supervision

i) After licensing, implementation of risk-shielding measures (full implementation shall be a pre-condition for licensing) shall be reviewed through inspection of the subsidiary bank or through submission of reports and other means. In case of improper implementation of risk-shielding measures, or in instances where it is determined that the previously determined risk-shielding measures are inadequate, the supervisory authority may issue a business improvement order in accordance with Article 26 of the Banking Law.

ii) After licensing, the financial conditions of the non-financial parent entities shall be reviewed on a regular basis by requiring the subsidiary bank to submit such materials as the financial statements and auditor's reports of the non-financial parent entities indicating its management and financial conditions. (This shall be a pre-condition for licensing.) If it is discovered that the non-financial parent entities face financial or business difficulties, the subsidiary bank shall be required to submit a report indicating the impact on its own management, and pertinent plans and measures if necessary.

3. Ensuring the confidentiality of customer information when a subsidiary bank is involved in comprehensive business operations with its non-financial parent entities

(1) Basic principles

Protection of the confidentiality of customer information is a general requirement in conducting proper banking operations. Non-financial parent entities and their subsidiary banks, however, may attempt to maximize synergy effects through mutual sharing of their customer information. Therefore, it will be necessary to review whether appropriate measures have been taken to protect the confidentiality of their customer information. This issue is being currently examined by the relevant government ministries and agencies in preparation for drafting new legislation for the protection of personal information. Upon enactment, banks will be required to comply with the provisions of such legislation. The supervisory authority shall consider the following matters for the time being.

(2) Matters to be considered in licensing and on-going supervision

a. Matters to be ascertained in the process of licensing

It shall be reviewed whether or not the subsidiary bank takes proper measures to protect the confidentiality of customer information. Specifically, where customer information is to be shared with other entities, it shall be reviewed whether or not, at the minimum, procedures are in place a priori for obtaining the customer's explicitly informed approval concerning entities with which information is to be shared, and objectives and method of the use for information.

b. Matters to be considered in on-going supervision

After licensing, implementation of measures for the protection of the confidentiality of customer information shall be reviewed through inspection of the subsidiary bank or through submission of reports.

4. Risk management and profitability in cases where the asset structure of the bank is biased towards securities including government bonds

(1) Basic principles

Under current capital adequacy requirements focusing primary on credit risks, capital adequacy requirements for banks whose asset structures are biased towards securities including government bonds, instead of outstanding loans, will be very low because their credit risks will be negligible. On the other hand, in the light of their distinct business structure from conventional banking, capital adequacy requirements must be adopted which properly reflect the risks to which such banks are exposed, including interest-rate risks and operational risks.

If such banks do not take the credit risks which are commonly taken by conventional banks, they will be unable to earn the returns on such risks. This point must be taken into account in examining future income and expenditure projections.

(2) Matters to be considered in licensing and on-going supervision

a. Matters to be reviewed in the process of examination for licensing

i) For banks whose asset structures are biased towards securities including government bonds instead of outstanding loans, it shall be reviewed whether or not the capital base is adequate to cover interest-rate risks, operational risks and other types of risks, in the light of their distinct business structure from conventional banking, and whether or not proper risk management measures, such as the asset-liabilities management, are being implemented.

ii) In examining future income and expenditure projections, it shall be reviewed whether or not revenue sources can be identified and whether or not such sources can be expected to continue to generate stable and reliable revenues in the future. Furthermore, it shall be reviewed whether or not contingency plans are in place to cope with situations in which conditions on which profitability projections are based substantially deteriorate, and whether or not revenue which can cover ordinary expenses can be maintained even under such conditions.

iii) For banks undertaking nationwide settlement functions, it shall be reviewed whether or not reliability of settlement functions can be ensured.

b. Matters to be considered in on-going supervision

It shall be reviewed whether or not the capital base confirmed at time of licensing is being maintained, and whether or not proper risk management measures, such as ALM, are being implemented. This shall be done through inspection, submission of reports, or other means.

It shall be reviewed whether or not the revenue sources confirmed at the time of licensing are generating their expected revenues, and whether or not there have been any substantial changes in the conditions on which profitability projections were based. In cases where revenues are falling below projections, it shall be reviewed whether or not proper measures have been taken. This shall be done through submission of reports or other means.

5. Issues related to customer protection for banks operating through ATMs and over the Internet with no face-to-face contact with customers

(1) Basic principles

Existing banks have already started to provide electronic financial transaction services using the Internet and other means. Consequently, it will be necessary to review the current regulations and supervisory methods to ensure that they correspond to the features of electronic transactions to protect users effectively.

It will be necessary for banks operating solely through unmanned outlets using ATMs or through the Internet with no face-to-face contact with customers to establish appropriate rules and internal controls to substitute the various functions provided by conventional manned bank offices and branches. In introducing new services based on information technologies, systems must be developed to allow ordinary customers to use these services safely and conveniently without special training or instruction.

In view of the above, the following matters shall be considered in licensing and supervising banks operating solely through the Internet and ATMs with no face-to-face contact with customers.

General regulations and supervisory requirements pertaining to electronic financial transactions shall be reviewed in light of the report (April 18, 2000) submitted by the Electronic Financial Services Study Group whose members are experts in relevant fields.

(2) Matters to be considered in licensing and on-going supervision

a. Matters to be reviewed in the process of licensing

i) It shall be reviewed whether or not banks maintaining no physical branches and outlets have developed systems for the following:

[1] Responding to customer complaints and inquiries
[2] Responding to customer needs when system is down
[3] Compliance with statutory rules of explanation to customers
[4] Compliance with disclosure rules
[5] Confirmation of customers' identities for prevention of money laundering

ii) With regard to income and expenditure projections, it shall be reviewed whether or not contingency measures are in place to cope with a deterioration in the business environment, including the entry of new competitors and the obsolescence of existing systems, and whether or not a certain level of revenue can be maintained even under such conditions.

iii) In view of customer sensitivity in terms of contracts including interest rates and the ease with which trading relations can be canceled or altered, it shall be reviewed whether or not proper contingency measures are in place to ensure adequate liquidity in case of temporary and large-scale withdrawal by customers.

iv) It shall be reviewed whether or not an adequate level of security system has been achieved, and whether or not safety and control procedures for the system (including control of the consigned) and contingency measures when a trouble occurs. (Banks shall be required to submit an evaluation report prepared by external organizations.)

b. Matters to be considered in on-going supervision

It shall be reviewed whether or not countermeasures confirmed at the time of licensing are being implemented. This shall be done through inspection, submission of reports, or other means.

II. Application to Existing Banks

The points which need special attention in supervision contained in Section I above shall generally apply to the supervision of existing banks in the following instances; when an existing bank is acquired by non-financial parent entities when an existing bank utilizes customers' personal information, and when an existing bank initiates Internet banking.

Matters pertaining to licensing and supervision contained in Subsections 1 through 3 in Section I above shall apply whenever non-financial parent entities take possession of a bank holding company.