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Rethinking regulation of financial groups

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Executive Summary

On December 22, 2015, the Financial System Council's Working Group on Regulation of Financial Groups issued a report[1]. Following is a summary of the report's recommended reforms interspersed with my personal opinions[2].

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NOTE

1) http://www.fsa.go.jp/singi/singi_kinyu/tosin/20151222-1/01.pdf (in Japanese).

2) Although I participated in the Working Group's discussions as a member of the Financial System Council, all opinions expressed herein are my own, not the Working Group's or Financial System Council's.

3) http://fis.nri.co.jp/~/media/Files/publication/kinyu-itf/en/2015/lakyaravol217.pdf

Background

The Working Group on Regulation of Financial Groups (chaired by Waseda University law professor Shinsaku Iwahara) was established at the behest of financial services minister Taro Aso at a March 3, 2015, meeting of the Financial System Council and its Sectional Committee on the Financial System. Mr. Aso gave the Working Group a mandate to study how to best update regulatory and institutional arrangements pertaining to financial groups in light of ongoing changes, including diversification and internationalization of their operations. The Working Group drafted its report based on its discussions at a series of nine meetings dating back to May 2015.

FinTech, the intersection of finance and IT, has been garnering growing attention in recent years[3]. Some Western financial institutions have been actively acquiring equity stakes in and/or building alliances with FinTech startups. In Japan, by contrast, financial institutions are arguably constrained from investing in FinTech companies by regulations on banks and bank holding companies. Meanwhile, Japanese financial groups are breaking new ground in terms of management strategy. The megabanks, for example, are relying on their overseas and non-bank subsidiaries for a growing share of their consolidated earnings. Even regional financial banks are merging into inter-regional financial groups controlled by holding companies.

In recognition of such, the Working Group was charged with recommending management and regulatory best practices that would enable financial groups to manage their operations more flexibly and efficiently. Below I summarize the gist of the Working Group's report, focusing on recommended legislative amendments and other regulatory reforms.

Management best practices

The report's first chapter covers management best practices for financial groups. It begins with an overview of the management status quo at megabank groups and regional bank groups controlled by holding companies. It then discusses how such financial groups should ideally manage themselves. The report stresses the importance of approaching this issue from the standpoint of how to build effective management models tailored to individual groups' respective operational footprints, scale, risk profiles, management strategies and other attributes instead of a one-size-fits-all model. Regarding what specific types of management models are most advisable, the report notes that financial groups are in communication with regulatory authorities on a daily basis and recommends that banking laws and regulations set rules applicable to all financial groups that operate banking businesses but not favor any one management model over others. In other words, it recommends basically giving financial groups free rein to select whatever management model best fits their actual state of affairs.

The report thus advocates against imposing one-size-fits-all rules regarding financial groups' management models, including organizational configuration (e.g., institutional design in compliance with the Companies Act, dual directorships). It does so based on a recognition that, while superficially similar, financial groups controlled by bank holding companies are organizationally diverse and such diversity is in fact desirable.

To ensure that financial groups build and operate effective management models, the report recommends that the government enact laws with explicit provisions on the financial and management functions that should be fulfilled by financial groups' holding companies or, absent a holding company, parent banks. This recommendation recognizes that financial groups possess functional commonalities despite differences in their management models[4].

4) The report listed the following examples of specific provisions regarding financial group management that should be enshrined in statute:
- Establishment of group management policies
- Establishment of group earnings, risk-taking and capital policies
- Development and operation of a group management model
- Development and implementation of group compliance arrangements and management of conflicts of interest
- Formulation and implementation of group rebuilding plans (particularly for G-SIFIs)

The report also advocates flexibly permitting information required for effective group management to be collected and appropriately shared among group companies, given that the Cabinet Office Ordinance on the Financial Instrument and Exchange Act already permits information sharing on matters related to management of subsidiaries.

Consolidation of financial groups' common/duplicative operations

The report's second chapter pertains to consolidation of financial groups' common/

duplicative operations. Some financial institutions, mainly regional banks, have expressed a wish to realize intragroup synergies and cut costs by consolidating group companies' common and/or duplicative functions within the group's holding company or a subsidiary. The report recommends regulatory reforms to allow such consolidation.

Specifically, the report first recommends revising existing regulatory restrictions on the scope of bank holding companies' operations, currently limited to management of subsidiaries and operations incidental thereto (Banking Act, Article 52-21). It recommends allowing holding companies to perform functions on a centralized or group-wide basis when doing so could be conducive to more unified or efficient management of the group as a whole.

It bears noting that the report stipulates that permission for holding companies to perform such functions should be contingent on effective group-wide oversight by the holding company's board of directors, including incorporation of outsiders' perspectives into such oversight. While the report advises against imposing one-size-fits-all requirements on the form of financial groups' management models as noted above, this stipulation strongly implies that inclusion of multiple highly independent nonexecutive directors on the board of directors is one benchmark of the effectiveness of a holding company's management of a financial group.

Group companies' common or duplicative operations could conceivably be consolidated within a specific intragroup subsidiary instead of within the holding company. In light of such a possibility, the report recommends that if a group consolidates multiple banks' duplicative operations within one of its subsidiaries, the group's holding company should be permitted to assume centralized management of the subsidiary instead of the banks being legally obligated to individually exercise management oversight[5].

5) Under current law (Banking Act, Article 12-2), individual banks that outsource operations are required to exercise oversight over the party to which the operations were outsourced.

Additionally, the report recommends that financial groups be granted flexibility to allow group companies with surplus cash to lend funds to other group companies with cash deficiencies at an internal interest rate, provided that such lending is synergistic and conducted in accord with explicit rules. With this recommendation, the Working Group is seeking an exception to the so-called arm's length rule (Banking Act, Article 13-2), which prohibits transactions between banks and their sister companies or subsidiaries except under arm's length terms.

Lastly, in light of globally active financial institutions' practice of providing services to Japan-based corporate groups' overseas affiliates or branches, the report recommends that licensing of banks to act as an agent or intermediary of a foreign bank be changed from one license per principal to blanket licenses covering a principal's entire corporate group.

Investments in FinTech companies

The report's third chapter discusses financial groups' IT usage and settlement-related services. In it, the Working Group recommends easing restrictions on equity investments in FinTech companies and settlement-related services provided to both intragroup and external customers.

Whereas Western, mainly US, financial groups are already acquiring equity stakes in FinTech companies and even operators of e-commerce malls, such investments may not meet the definition of finance-related businesses (businesses related or incidental to banking) or ancillary businesses (businesses ancillary to the operations of banks or their affiliated securities firms, insurers and trust banks) in which Japanese financial groups are permitted to engage under current law. In light of such, the report recommends that banks and bank holding companies be permitted to invest, subject to regulatory approval, in subsidiaries and other investees operating businesses that contribute or may contribute to upgrading the services provided by banks.

The report advises regulatory authorities to decide whether to grant permission for such investments in light of the intent behind the prohibition against banks and financial groups engaging in businesses not related or ancillary to financial services. For example, the report recommends that regulators confirm that a proposed investment (1) would not be detrimental to the group's financial soundness, (2) is unlikely to pose a material risk of risk contagion to the group's bank(s) (e.g., due to risk correlation with the banking business), (3) poses no threat of harm due to conflicts of interest or abuse of a superior position and (4) would likely contribute to expansion of the group's financial service offerings or expansion of opportunities to provide financial services.

If an investment is deemed worthy of approval by regulators, the report states that depending on whether the investment will be owned by a bank or bank holding company, the permissible maximum ownership percentage could differ based on the nature and risk of the prospective investee company's business, given that effectiveness of risk isolation differs depending on whether the risk originates from a subsidiary or sister company.

Under current law, banks' ownership of nonfinancial companies is limited to a maximum of 5% of total voting rights (Banking Act, Article 16-3(1)). For bank holding companies, however, the maximum is 15% (Banking Act, Article 52-24(1)), including shares owned by not only the holding company but also its subsidiaries. The Working Group was presumably mindful of this difference.

Some readers may be concerned that the Working Group is in favor of automatically allowing financial groups organized in the form of a bank holding company to own larger percentage stakes in FinTech companies than if the investment were made directly by a bank not controlled by a holding company. However, the report explicitly states that if the maximum permissible ownership percentage differs between a bank holding company and a bank, the difference would be attributable to investee-specific factors such as the nature of its business or its risk profile. A simplistic interpretation that acquirers not organized as bank holding companies would invariably be at a disadvantage when seeking regulatory approval of pending acquisitions is misguided.

Nonetheless, in the event that a financial group's investee is facing a material risk of bankruptcy, the prospective systemic repercussions would in fact differ depending on whether the investee is owned by a bank holding company or directly owned by a bank. Current law therefore restricts banks to smaller equity stakes than bank holding companies are allowed to own. When actually vetting pending equity investments in specific FinTech or other companies, regulators should of course consider potential risk contagion channels and the magnitude of systemic impacts, in addition to the nature of the investee company's business and the acquiring bank or financial group's management acumen.

Intragroup/external settlement-related services

The report also recommends revising existing regulations that require bank subsidiaries and banks' sister companies that provide settlement-related IT services or other such services ancillary to banking operations to derive at least 50% of their total revenues from the banking group with which they are affiliated.

The rationale behind this recommendation is that if such revenue-dependence requirements are applied to services such as IT system development that entail large upfront costs but subsequently reduce recurring expenses, they may make banks hesitant to undertake strategic IT investments because the parent banking group would incur a prohibitively heavy cost burden, particularly during the initial development phase.

Issues to be addressed further

In addition to the recommended reforms discussed above, the Working Group addressed several other issues on which it failed to reach a consensus and therefore did not recommend specific reforms. Instead, its report merely presented focal points for further deliberation on these issues.

One such issue is questions that can arise under the Companies Act when a holding company seeks to effectively assert management control over a financial group. For example, holding companies are shareholders of their bank subsidiaries but do not have specific command authority over the bank subsidiaries' directors under the Companies Act. To rectify this omission, the holding company and its bank subsidiaries could enter into management agreements, but whether such agreements would be legally enforceable is questionable. Another issue raised by the report is whether, in cases where holding companies manage their financial groups through effective oversight functions, requiring the banks within those financial groups to also implement governance controls such as establishing a board of corporate auditors would constitute regulatory overkill.

However, the Working Group concluded that these issues warrant careful consideration from the standpoint of whether financial groups alone need to be subject to different controls than ordinary nonfinancial companies. It recommended continued, deeper deliberation on this point.

Another issue on which the Working Group was unable to reach a consensus is equal competitive footing between financial groups that include one or more traditional banks and new-entrant banks owned by nonfinancial parent companies. Regulatory treatment of parent companies of new-entrant banks differs substantially from that of financial groups comprising traditional banks. For example, parent companies of new-entrant banks are exempt from the regulations imposed on financial groups because they do not meet the definition of a bank holding company[6]. Instead, they are regulated merely as a major shareholder of a bank.

6) Under current law, a bank holding company is defined as a company whose equity holdings in subsidiaries account for over 50% of the value of its total assets (Antimonopoly Act, Article 9(4)(i)) and whose subsidiaries include at least one bank. Nonfinancial companies that do not meet the Antimonopoly Act's definition of a holding company are not subject to regulation as a bank holding company, even if they are a bank's parent company.

The Working Group said that further study of the adequacy of regulatory supervision of nonfinancial groups that own banks may be necessary from the standpoint of ensuring the financial system's soundness. Meanwhile, it cautioned against imposing excessive restrictions on entry into the banking industry from other sectors from the standpoint of fostering innovation. On this issue, the Working Group again concluded that deeper deliberation is warranted.

Conclusion

I expect existing laws to be amended in accord with the recommendations in the Working Group's report. If bills amending the Banking Act and related laws are submitted to the regular Diet session that begins in early January and are expeditiously passed, new financial group regulations could take effect as early as FY2017. Legislative developments and financial institutions' response thereto bear watching going forward.

about NRI

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