INTERNATIONAL FINTECH *REVIEW*

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Beaumont Capital Markets

KPMG IN JAPAN

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BIO

Nobu joined KPMG Consulting in 2021 and has provided data analytics and data strategy projects for financial companies, as well as global financial centre related projects designed to attract overseas fintech companies to Japan.

Prior to KPMG Consulting, he worked for Mizuho Research & Technologies, an IT and consulting company within Mizuho Financial Group, and served as the Senior Technology Manager for creating new business based in San Francisco. Before moving to San Francisco, he worked for the management accounting team, creating customer analysis and product portfolio analysis in order to establish the management plan.

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BIO

Kenji joined KPMG AZSA in 2014 and has provided various advisory services related to regulation within the financial sector, mainly crypto assets and other digital tokens, as well as web3.

Prior to AZSA, he worked at the Financial Services Agency (FSA) from 2003 within the enforcement division of the Securities and Exchange Surveillance Commission. While at the FSA, he was also seconded to the US Commodity Futures Trading Commission and then to the Organization for Economic Co-operation and Development (OECD), as well as worked in the international affairs division.

Prior to the FSA, he worked within the fund management business on Japanese stocks at various major financial institutions and foreign asset management companies.

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BIO

Tomo Sekiguchi is a partner of KPMG AZSA LLC. While he is responsible for the firm's initiatives regarding corporate and sustainability disclosure including assurance over sustainability reporting, he also provides accounting and assurance related services to fintech, crypto assets, and blockchains.

He has strong expertise in the areas of standard-setting and regulation obtained through his previous experiences. Such experiences include working for the Accounting Standards Board of Japan (ASBJ) as a full-time board member and for the International Auditing and Assurance Standards Board (IAASB) as a part-time board member.

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Japan - Key Developments & the Latest Trends in the Fintech Market

I. Introduction

The Fintech market has been expanding at an unprecedented speed both in terms of scale and variety. Japan is not an exception. To keep pace with the market developments, there continues to be constant changes in relevant laws, regulations and standards. In this article, we will explain (i) the overview the fintech market, (ii) recent developments and challenges regarding relevant laws and regulations to facilitate the developments, and (iii) relevant developments in accounting, auditing and tax areas.

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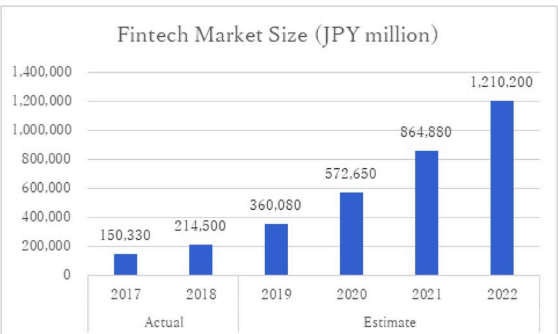
II. Overview of Fintech Market

Japan is the third largest economy in the world after the United States and China. According to the study of Yano Research Institute, Ltd., fintech-related businesses in 2018 amounted to approximately JPY214.5 billion (equivalent to USD 1.53 billion), and are expected to grow in excess of JPY1,210 billion (equivalent to USD 8.64 billion) by 2022 (CAGR 51%). The largest fintech segment is the bank segment where payments with smartphones and utilising blockchain are expected to grow. Although the size of the insurance and brokerage segments is smaller than the banking segment, they are expected to grow as well.



(Source: Yano Research Institute, Ltd. "FinTech Market in Japan: Key Research Findings 2019")

Exchange rate **US$1 = JPY140**

The following represents key features regarding fintech trends in Japan.

1. Embedded Finance

There exist notable developments around embedded finance, where startups provide services to both non-financial and financial companies as enablers. For example, one fintech-focused startup provides services that would help companies launch the brokerage service or insurance service to their customers. In addition, another startup provides the settlement service to several banks. Further, financial companies also act as enablers in Japan. For example, one of the net banks provides services relevant to banking functions via API (Application Programming Interface).

There are some unique characteristics of Embedded Finance in Japan. First, enablers are usually license holders. In the Embedded Finance field, the players are ordinarily divided into three categories: brands, enablers and license holders; however, enablers (as player of the second category) act as license holders (as player of the third category). The second unique characteristic is that financial companies are users of embedded finance. This is because the speed of digital transformation at traditional financial companies is relatively slow, and traditional financial companies seek to utilise embedded finance so as to accelerate their digital transformation. According to Fuji Chimera Research Institute, Inc. "2022 Future Outlook for Digital Transformation Market <Market Edition>", there will be 50 companies which provide embedded finance services by FY2030.

2. Greater Use of Data

Secondly, both financial institutions and fintech startups focus on data. One of the most notable trends is that financial institutions are more focused on alternative data, including data that are made readily available with advancement in technology (e.g., satellite image). In Japan, however, the use of alternative data is just beginning, and there are many problems such as lack of clarity around rights and obligations involving alternative data, lack of human resources with both financial knowledge and data analysis skills, and unestablished methods for evaluating costs and benefits. In 2021, the Japan Alternative Data Accelerator Association (JADAA) was established so as to solve these problems, and 75 organisations have joined membership of the JADAA as of May 2022.

As utilising data is the trend not only for financial institutions but also for other industries, the market size for data utilisation consulting services is expected to grow from JPY 3.8 billion (equivalent to USD 27 million) in 2020 to JPY 20 billion (equivalent to USD 142 million) in 2030 (CAGR 18.1%) for the financial industry, according to Fuji Chimera Research Institute, Inc. "2022 Future Outlook for Digital Transformation Market <Market Edition>". This forecast indicates that the trend of utilising data will continue to grow and greater number of companies will seek to utilise data that is untouched.

3. Cashless Payments

Finally, cashless payments are growing at a rapid pace. According to Yano Research Institute "Domestic Cashless Payment Market 2022" (cited from Nikkei.com, April 20, 2022), the market size of cashless payments was JPY 98 trillion (equivalent to USD 700 billion) in FY2020 and is expected to grow to JPY 153 trillion (equivalent to USD 1,092 billion) in FY2025. However, according to the Ministry of Economy, Trade and Industry (METI), the cashless ratio in Japan was just 29.7% in 2020, which was much lower than other countries, although this trend is changing since the outbreak of COVID 19.
According to the study of Fuji Chimera Research Institute, Inc. "2022 Future Outlook for Digital Transformation Market <Market Edition>", the market size of cashless payments is expected to be 55% of the total domestic payments in FY2030. In 2021, one of the big tech companies acquired a Japanese fintech startup providing a smartphone payment app and free money transfer service between app users. It is said that Japan's low cashless rate is considered as a business opportunity. One of the challenges for the cashless payments is the profitability of the businesses. Especially as QR code payment companies have incurred a large amount of investment in marketing to expand their ecosystem. However, it is recognised that both QR code payment companies and retailers need to establish more sustainable business models to continue expanding cashless payments.

III. Developments and Challenges of Relevant Laws and Regulations

Laws and regulations are changing almost every year in response to the rise of fintech. The followings are notable developments of laws and regulations responding to the growth of fintech in Japan.

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1. Financial Service Intermediary

In November 2021, the amended Act on the Provision of Financial Services was enacted, introducing a new category, called "Financial Service Intermediaries". Intermediaries that fall under this new category are entitled to handle multiple types of financial services with a single license across financial business categories such as banking, securities, and insurance.

Until the amendment of the Act was enacted, handling financial intermediary services of multiple financial business categories had not been permitted unless an entity was registered to provide intermediary services for each business category. Therefore, the financial intermediary businesses were individually conducted for each of the business categories such as banking, securities, and insurance; and intermediaries were subject to respective regulation and supervision of different business categories. In addition, an entity that provides financial intermediary services was required to be affiliated with identified financial institutions, and such financial institutions were subject to regulatory requirements and were potentially liable for damages caused by the operation of affiliated financial intermediaries. This new financial services intermediary system enables financial services intermediaries to operate within multiple business categories with a single license, and also abolished the affiliation system. Hence, it is expected that financial services intermediaries provide a wide range of options to their customers, so that they can choose to decide which services could best meet their expectations.

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As an example, until the amended Act was enacted, the range of services permitted for a registrant of a banking-related financial intermediary was restricted solely to banking related services. However, once they obtain a license as a “Financial Services Intermediary”, they would be entitled to provide various intermediary services, such as those of securities and insurance businesses.

2. Digital Assets

Digital assets based on permissionless blockchains are expanding both in terms of asset types and market participants. In line with this growing trend, the legislative and regulatory framework in Japan has changed over time. As of April 2022, rights and obligations involving crypto assets and security tokens have already been legislated, and it is expected that those involving stablecoins will be legislated. The following provides an outline of the Japanese legislative and regulatory framework relating to digital assets, including Non-Fungible Tokens (NFTs).

(a). Crypto Assets

In 2017, the Payment Service Act (PSA) was amended. The amended Act required a crypto asset exchange business dealing with crypto assets (virtual currency) such as Bitcoin and Ethereum to be registered with the Financial Services Agency (FSA) and to be subject to regulatory requirements of the FSA. Subsequently, supervision was strengthened in the wake of the massive crypto asset spill accident in 2018; and even now, completing the registration process requires considerable time and efforts. As of the end of April 2022, thirty companies are registered with the FSA.

In 2020, the PSA was amended again. The amended Act requires an entity providing custody services of crypto assets to be subject to regulatory requirements of the FSA. At the same time, the custody business related to crypto assets was legislated in the Trust Business Act (TBA). As of April 2022, there is one trust company that incorporated a custody business related to crypto assets under the TBA into its business.

Traditional financial institutions such as banks are generally cautioned by regulators from handling crypto assets. As of April 2022, traditional financial institutions that provide services related to crypto assets to their customers are limited.

As the need for financial institutions to respond to the expanding trend of Web 3.0 is expected to increase in the future, there are calls to review such policies so as not to keep such financial institutions away from the emerging trend.

(b) Security Tokens

In 2020, the Financial Instruments and Exchange Act (FIEA) was amended to clarify regulations on tokenised securities.

Under the amended FIEA, when securities within the scope of the FIEA are tokenized, greater regulatory requirements including those of disclosure requirements, must be complied with compared to the case for traditional securities. Partly owing to such regulatory requirements, the number of actual use cases involving security tokens is relatively limited, although the issuance of security tokens that can be purchased by retail investors is expected to grow gradually. While the practice involving security tokens with permissioned blockchain infrastructure are advanced, initiatives for easing the handling of permissionless tokens (which are mainstream overseas) is under way.

Along with disclosure requirements, one of the major challenges to market expansion of security tokens is the absence of secondary markets, as the design and implementation of such markets would require significant time and effort.

(c). Stablecoins

In March 2022, the bill to amend the PSA and other laws that clarify the legal and regulatory status of so-called stablecoins whose value is linked to the value of fiat currency was submitted to the Diet. The amended law is expected to come into force in 2023.

According to the proposed amendment of the Act, the issuance of stablecoins backed by assets will be limited to banks, fund transfer companies, trust companies/banks; therefore, stablecoins such as Tether circulating overseas will not be handled in Japan. As with the security tokens described above, from the viewpoint of compliance with laws and regulations, it is anticipated that stablecoins based on permissioned tokens may take precedence.

(d). NFTs

As of April 2022, there are no clear regulations and legal definition of NFTs in Japan. For this reason, various companies are increasingly adopting NFT into their businesses.

There are many gaming companies in Japan, and game content is expected to drive the expansion of the NFT market in Japan. In addition to games, there are many contents unique to Japan that would fascinate the world. Hence, the metaverse and Web 3.0 markets in Japan may be driven not primarily by the financial industry, but by these content industries.

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IV. Developments in Accounting, Audit and Tax Areas

In pace with laws and regulations in fintech areas, there also exist changes in accounting, audit, and tax areas.

1. Developments in Accounting

Accounting standards and practice are still evolving in fintech area across countries including Japan.
One of the most evolving areas is accounting requirements related to crypto assets.

In March 2018, the Accounting Standards Board of Japan (ASBJ) issued Tentative Practical Solution No.38, *Accounting for Virtual Currencies under the Payment Services Act (PSA)*. The Practical Solution requires an entity holding virtual currencies (subsequently renamed as "crypto-assets" by the amendment of the PSA in 2018) to account for them in a manner similar to accounting treatments of financial instruments. In other words, an entity is required to measure a virtual currency held by users at FVTPL at each period end, when there is an active market for the virtual currency. If there is no active market for the virtual currency, an entity is required to follow cost-based accounting, while an impairment loss is required when its recoverable amount is below the original cost.
This Japanese accounting guidance may be considered unique, because International Financial Reporting Standards (IFRSs® Standards) do not provide specific requirements for accounting treatments of crypto assets. Instead, in June 2019, the IFRS Interpretations Committee published an agenda decision that clarifies that in many cases crypto assets be accounted for in accordance with IAS 38 Intangible Assets.

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In March 2022, the ASBJ published the Exposure Draft relating to accounting and disclosure requirements specific to security tokens. Simultaneously, the ASBJ published a Discussion Paper to explore appropriate accounting and disclosure treatments for the issuance and holdings of ICO tokens.

2. Developments in Audit

Due to challenges involving auditing financial statements of crypto asset exchange service providers, in June 2018, the Japanese Institute of Certified Public Accountants (JICPA) published its industry-specific practical guidance No.61, *Practice Guidance relating to Auditing Financial Statements of Crypto Asset Service Providers*, which has been updated from time to time.

The practice guidance provides relevant auditing considerations when auditing crypto asset exchange service providers, including those relating to (i) decision of accepting an audit engagement, (ii) selection of audit team members, (iii) understanding an entity and its environments as well as evaluating risks of material misstatements, and (iv) responding to assessed risks (including designing substantive procedures to perform). As part of the guidance, the guidance also provides illustrative internal controls that are expected to be in place at crypto asset exchange service providers.

3. Developments in Tax

Tax laws relating to fintech are also evolving in response to changes in practice. One of the most notable developments is the clarification of tax treatments involving crypto assets. In 2017, tax treatments regarding sales and holdings of crypto assets were clarified by the National Tax Agency of Japan. The National Tax Agency clarified in its publication that, in principle, income from crypto assets (including gains from sales of crypto assets) be classified as "other income" under the Income Tax Acts for individuals, meaning, for example, that gains and losses from crypto assets cannot be offset against each other.

In addition, tax requirements regarding sales and holdings of crypto assets were legislated as part of the amendment to the Corporation Tax Act in 2017, such that tax treatments of corporates became generally aligned with accounting requirements (as stated in "1. Developments in Accounting").


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