

Results of The Fourth Round FATF Mutual Evaluation Report of Japan: Protiviti Insights

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With the publication of The FATF Fourth Round Mutual Evaluation Report (MER) for Japan, the lull following the on-site review by the FATF's International Co-operation Review Group (ICRG) has come to an end. With the publication, it is essential to promptly update and continuously enhance current measures, while keeping a close eye on the regulatory trends.

This flash report is to provide a summary of the key points in the MER for financial institutions to consider future developments.

Key points in this report

The FATF's assessment of financial institutions' anti-money laundering and counter-terrorist financing (AML/CFT) system shows that Japan falls short of meeting FATF's expectations, and that financial institutions are required to improve their AML/CFT system in the following areas:

1. Respond promptly to the MER and to the various measures taken by the regulatory authorities.
2. Deepen their knowledge of anti-money laundering and counter-terrorist financing and understanding of relevant risks across the organizations, and use this knowledge and understanding to inform the enterprise-wide risk assessment.
3. Enhance ongoing Customer Due Diligence (CDD) and transaction monitoring.

1. Results of the FATF Fourth Round Mutual Evaluation Report of Japan

The FATF Fourth Round Mutual Evaluation of Japan was conducted by the ICRG on-site from

late October to mid-November 2019. After the on-site visit, the MER result was presented in the FATF Plenary held in June 2021.

On the same day when the Financial Action Task Force (FATF) published the MER on August 30th, 2021, the Ministry of Finance (the MOF) website announced that the country's AML/CFT system was effective mainly due to the international cooperation, and as a result, the country was assessed as "Enhanced Follow-up." The announcement also states that the publication of MER gave rise to the "Policy Council on Anti-Money Laundering and Counter-Terrorist Financing and Proliferation Financing", which is co-chaired by both the National Police Agency and the MOF. The Council will formulate an action plan for the next three years and, going forward, regularly publish follow-up status on the progress.

2. Summary of the Results

In addition to the Technical Compliance of the 40 FATF Recommendations, 11 Immediate Outcomes (IOs) have been added in the fourth round of mutual evaluations, assessing the compliance by financial institutions and Designed Non-Financial Businesses and Professions (DNFBPs).

To summarize, 8 out of 11 IOs were assessed as moderate level of effectiveness (ME), 10 out of 40 technical compliance assessments were partially compliant (PC), and 1 was non-compliant (NC), indicating that Japan is falling short of meeting FATF's expectations. The evaluation of effectiveness was particularly severe (as shown in the following table).

Table 1. Effectiveness Ratings

IO.1	Risk, Policy and Coordination	SE
IO.2	International Co-operation	SE
IO.3	Supervision	ME
IO.4	Preventative Measures	ME
IO.5	Legal Persons and Arrangements	ME
IO.6	Use of financial intelligence	SE
IO.7	ML investigation and prosecution	ME
IO.8	Confiscation	ME
IO.9	TF investigation and prosecution	ME
IO.10	TF preventative measures	ME
IO.11	PF financial sanctions	ME

Note: Effectiveness ratings can be either a High - HE, Substantial - SE, Moderate - ME, or Low - LE, level of effectiveness.

After the fourth round of mutual evaluations, each jurisdiction is classified as “Regular Follow-up Country,” “Enhanced Follow-up Country” or “Under Increased Monitoring,” and goes through a follow-up process.

As mentioned above, more than 8 out of 40 technical compliance areas were assessed as failing level (NC or PC), and more than 7 out of 11 IOs were assessed as failing level (LE or ME). As a consequence, Japan will be subject to a more stringent follow-up by the FATF compared to regular follow-up countries.

Regular Follow-up Country (Passing Level)
Italy, UK, Russia, Spain, etc.
Enhanced Follow-up Country (Failing Level)
Japan, US, China, Korea, Australia, Switzerland, Mexico, etc.
Under Increased Monitoring (Failing Level)
Iceland, Turkey

(Prepared by Protiviti based on sources of the FATF, etc.)

Even though not falling “Under Increased Monitoring”, Japan is still assessed as an “Enhanced Follow-up Country.” In this regard, Japan is required to report its progress to the FATF three times prior to the next follow-up assessment, which is in five years (2026). If there is no progress in improving the situation during this period, there is a risk that the FATF may publicly criticize the country for its lack of progress. In fact, in the follow-up of The Third MER of Japan, the

Table 2. Technical Compliance Ratings

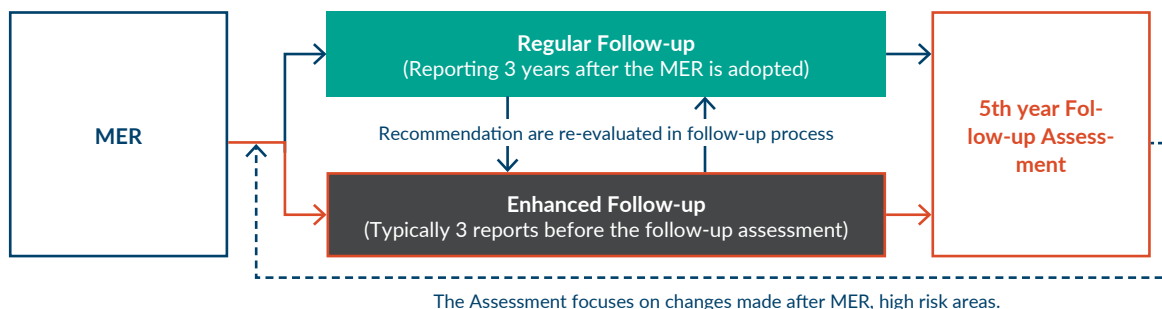
R.1	Assessing risks & applying a risk-based approach	LC
R.2	National cooperation and coordination	PC
R.3	Money laundering offences	LC
R.4	Confiscation and provisional measures	LC
R.5	Terrorist financing offence	PC
R.6	Targeted financial sanctions related to terrorism & TF	PC
R.7	Targeted financial sanctions related to proliferation	PC
R.8	Non-profit organisations	NC
R.9	Financial institution secrecy laws	C
R.10	Customer due diligence	LC
R.11	Record keeping	LC
R.12	Politically exposed persons	PC
R.13	Correspondent banking	LC
R.14	Money or value transfer services	LC
R.15	New technologies	LC
R.16	Wire transfers	LC
R.17	Reliance on third parties	N/A
R.18	Internal controls and foreign branches and subsidiaries	LC
R.19	Higher-risk countries	LC
R.20	Reporting of suspicious transaction	LC
R.21	Tipping-off and confidentiality	C
R.22	DNFBPs: Customer due diligence	PC
R.23	DNFBPs: Other measures	PC
R.24	Transparency and beneficial ownership of legal persons	PC
R.25	Transparency and beneficial ownership of legal arrangements	PC
R.26	Regulation and supervision of financial institutions	LC
R.27	Powers of supervisors	LC
R.28	Regulation and supervision of DNFBPs	PC
R.29	Financial intelligence units	C
R.30	Responsibilities of law enforcement and investigative authorities	C
R.31	Powers of law enforcement and investigative authorities	LC
R.32	Cash couriers	LC
R.33	Statistics	LC
R.34	Guidance and feedback	LC
R.35	Sanctions	LC
R.36	International instruments	LC
R.37	Mutual legal assistance	LC
R.38	Mutual legal assistance: freezing and confiscation	LC
R.39	Extradition	LC
R.40	Other forms of international cooperation	LC

Note: Technical Compliance ratings can be either a C - Compliant, LC - largely compliant, PC - partially compliant or NC - non-compliant.

FATF pointed out the delay in the progress and issued a statement urging Japan to take prompt actions. If the progress of Japan AML/CFT system is questioned by FATF, foreign countries

may take enhanced measures against Japanese financial institutions domiciled in their jurisdictions, which could have a significant impact on transactions, such as correspondent banking

transactions and international wire transfers. Therefore, it is necessary to take this follow-up process seriously.



Prepared by Protiviti based on the FATF "Procedure for the FATF Fourth Round of AML/CFT Mutual Evaluation"

3. Result of the Assessment of Effectiveness of Financial Institutions' ML/TF Risk Management System

The FATF fourth round of mutual evaluations not only focuses on the assessment of technical compliance, but also assessment of the effectiveness. That is to say, on top of the assessment of conventional technical compliance with the FATF 40 Recommendations, the recently introduced assessment of effectiveness (IOs) is covered, which is conducted through on-site interviews with financial institutions.

In that sense, to interpretate the MER and gain some insights, priority should be given to two IO assessment results: IO.4 (Preventative Measures), particularly relevant to financial institutions and IO.3 (Supervision), an assessment of the effectiveness of regulatory supervision, which can assist in predicting future regulatory trends. Since the results of technical compliance assessments also contain information that may lead to future revisions of regulations, to be specific, understanding FATF's comments as to those recommendations with assessments as failing level (NC or PC) will provide insights on this matter.

(1) Major points in IO.4

The IO.4 assessment result is "Moderate Level" of effectiveness, which indicates that Japan falls short of meeting FATF's expectations. The highlights in the assessment are as follows:

- **Limited understanding of money laundering and terrorist financing risks and anti-money laundering and terrorist financing obligations among financial institutions.**

The FATF found that most financial institutions have a limited understanding of the money laundering and terrorist financing (ML/TF) risks, as well as of their AML/CFT obligations; in other words, most financial institutions only have a superficial understanding of ML/TF risks.

Variation in the control measures performed and delays in implementation of control measures to fulfill regulatory obligations across the financial sector remain challenges to the supervisory authorities. Therefore, standardized required actions and an appropriate timeline to meet regulatory obligations are needed to fulfill obligations legally, regulatorily, and supervisory.

- **There is room for improvement in Customer Due Diligence (CDD) and transaction monitoring**

The FATF has identified challenges in CDD and transaction monitoring amongst most financial institutions.

The MER states that there are significant gaps in the ongoing CDD framework of those firms that have a large number of existing customer accounts with information not updated and risk assessment not revisited. A warning sign has been issued for both CDD and EDD (En-

hanced Due Diligence) in respect to the accuracy of data obtained and the appropriateness of means to obtain such data. For example, solely relying on customer declarations of beneficial owners is insufficient. As for the EDD measures on Politically Exposed Persons (PEPs), it is suggested that applicability should be on domestic PEPs and foreign PEPs alike. In addition, it is noted that appropriate EDD measures are not taken, as in many cases, EDD measures performed are limited to standard procedures, such as customer identity verification and list matching screening.

With respect of transaction monitoring, the FATF has warned that although some financial institutions have basic transaction monitoring systems in place, the effectiveness of these systems is questionable. Particularly, the FATF says that a very limited number of financial institutions have adequate transaction monitoring systems that focus on customer attributes and transaction patterns, and as a result, many financial institutions are facing a very high rate of false positives and other issues. In addition, there are other comments questioning the effectiveness of the system, such as the insufficient use of customer identity verification and inadequate risk awareness on a group level.

- **Doubts about the effectiveness and its enforceability of the FSA Guidelines**

The FATF's comments on IO.4 were not only about the preparedness of the financial services industry, but also about the preparedness of supervisory authorities. Per the FATF evaluation, the FSA Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism ("the FSA Guidelines") issued in 2018 were positioned as "enforceable" even though they were originally positioned as guidelines. That being said, the enforceability level of the FSA Guideline should be increased.

On the other hand, the FSA currently requires the three megabanks to develop a higher level of preparedness through the issuance of "AML/CFT Benchmarks for the Three Megabanks." The level of the FSA Guidelines should

be increased to a level that is consistent with the Benchmarks. It goes without saying, to ensure the compliance with the FSA Guidelines, standardized requirements and an appropriate timeline for meeting regulatory obligations should be established for all financial institutions.

- **The AML/CFT system of Virtual Asset Service Providers (VASP) is at an early stage with room for improvement**

In 2019, the FATF introduced some changes in the evaluation methodology where VASP, in addition to financial institutions and DNFBPs, is added to the evaluation scope. Japan became the first country to be examined according to this new methodology. The FATF acknowledges the readiness of VASPs has been led by the government and the industry association to a certain level but is still at an early stage. Just like most financial institutions, there is also room for improvement.

(2) Major points in IO.3

The IO.3 assessment result is "Moderate Level" of effectiveness, which indicates that Japan falls short of meeting FATF's expectations. The main results of the evaluation include the following points:

- **The status of risk-based supervision by the financial authorities is at an early stage, but is improving positively and continuously**

In 2018, the FSA established a dedicated AML/CFT Policy Office, and at the same time the FSA Guidelines were issued. Since then, to achieve supervision through risk-based approach (RBA), the FSA has been conducting a survey (a request for reporting) on all financial institutions, assessing their responses, and performing follow-up monitoring. However, it is still at an early stage.

As in IO.4, regarding the effectiveness of the FSA Guidelines, the MER suggests that the level of the enforceability of the FSA Guidelines should be increased and a deadline for the implementation should be set. In addition, development of supervisory guidelines on how to implement the FSA Guidelines is needed.

- **Issues with the frequency and comprehensiveness of regulatory supervision and inspections and needs for an overall supervisory personnel development**

The FATF acknowledged the effectiveness of the supervision over those financial institutions with which the FSA had direct dialogue but questioned the effectiveness of the supervision over the other financial institutions and suggested that similar efforts should be extended to the entire financial sector.

It is also noted that additional supervisory resources for AML/CFT regulatory oversight are desirable and that, besides the allocation of supervisory resources, a close cooperation with local regulatory supervisors, namely Local Finance Bureaus, to strengthen local oversight should also be in place.

- **Needs for deterrent administrative action and corrective measures to be held against financial institutions**

The FATF has assessed that the financial supervisory authorities, including the FSA, have failed to impose effective and deterrent sanctions against financial institutions. Although some credit was given to the authorities for the deterrent measures taken against VASP in the past.

(3) Major points in technical compliance

As a result of the technical compliance assessments, 10 were assessed as partially compliant (PC) and 1 was assessed as non-compliant (NC). The main points for financial institutions in the recommendations assessed as NC or PC will be measures against terrorist financing, treatment of NPOs and PEPs, and treatment of beneficial owners.

Table 1: Points in technical compliance

#	Recommendations	Rating	Points
2	National cooperation and coordination	PC	<ul style="list-style-type: none"> • Japan does not have a signature national AML/CFT policy or set of policies. • Although Japan has the Ministerial Meeting Concerning Measures Against Crimes and the FATF Inter-Ministerial Meeting, the mandate of them do not include responsibility for AML/CFT national policies and do not contain a general policy of co-ordination of actions for AML/CFT purposes
5	Terrorist financing offence	PC	<ul style="list-style-type: none"> • Japan has a deficiency related to the criminalization for providing or collecting assets for a terrorist organisations or individual terrorist in the absence of a link to a terrorist act or acts. • The sanctions of the TF Act are not proportionate and dissuasive.
6 and 7	Targeted financial sanctions (TFS) related to terrorism & terrorist financing Targeted financial sanctions related to proliferation	Both are PC	<ul style="list-style-type: none"> • Japan's system implements TFS, but with delay. • It is unclear whether TFS applies to funds or other assets of persons and entities acting on behalf of, or at the direction of designated persons or entities.
8	Non-profit organisations	NC	<ul style="list-style-type: none"> • Japan supervises its NPO sector for general transparency and good governance purposes but does not do so based on risk of TF abuse. • Although Japan conducts TF risk assessments in NPOs, it has neither identified which Japanese NPOs or types of Japanese NPOs are at risk of TF abuse nor adequately assessed overall TF risk in the sector.
12	Politically exposed persons	PC	<ul style="list-style-type: none"> • There is an absence of specific measures applicable to foreign PEPs as such measures are not equivalently required by all regulators. • The above measures have not been applied to persons who have been entrusted with a prominent function by an international organisation and their family members/close associates.

22 and 23	DNFBPs: Customer due diligence DNFBPs: Other measures	Both are PC	<ul style="list-style-type: none"> Deficiencies for FIs are also relevant for DNFBPs. Professionals, such as lawyers, are only required to conduct customer identification/verifications, and no other CDD matters, including suspicious transaction reporting. There is no clear requirement for DNFBPs to implement group-wide programmes to all branches and majority-owned subsidiaries, nor to ensure that their foreign branches and majority-owned subsidiaries apply AML/CFT measures consistent with the home country.
24	Transparency and beneficial ownership of legal persons	PC	<ul style="list-style-type: none"> Timely access to accurate beneficial ownership information on legal persons is not available to competent authorities.
25	Transparency and beneficial ownership of legal arrangements	PC	<ul style="list-style-type: none"> There are no specific measures placed on trustees to disclose their status to an FI or DNFBP, nor requirements on civil trusts to hold information.
28	Regulation and supervision of DNFBPs	PC	<ul style="list-style-type: none"> DNFBP supervisors have not implemented supervision on a risk-based approach.

4. The Direction of Anti-Money Laundering and Counter-Terrorist Financing Measures in Financial Institutions: What Should Be Done Now?

(1) Respond immediately to the MER and to the regulatory authorities' various measures taken based on the MER

As the regulatory authorities have formulated the “Action Plan for Anti-Money Laundering and Combating Terrorist Financing and Proliferation Financing” (the Action Plan) to implement various measures, it is necessary for each firm to analyze the consequent impact while vigilantly examining the MER and the Action Plan.

In addition, a more urgent response is required than just the action taken by the FSA that seemingly has acted proactively after a series of communications with the FATF prior to the MER publication. Some well-known examples are as follows: (1) February 2021 revision of the FSA AML/CFT Guidelines (see <https://www.protiviti.com/JP-jp/insights/aml-cft-guidelines>), (2) The issuance of the “Frequently Asked Questions (FAQ) on the Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism” in March of the same year.

Compared to the previous revision (dated April 2019) of the FSA Guidelines, in the February 2021 revision issued before the release of MER, many new “required actions for a financial institu-

tion” across various sections have been added and there is a new section on “trade finance,” which is a requirement in the Benchmarks tailored for the three megabanks. This action is considered as a response to the FATF’s comments to bring consistency across the financial industry by increasing the level of enforceability of the FSA Guideline as with the Benchmarks. In addition, the “Frequently Asked Questions (FAQ) on the Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism” clarifies the objectives and contents of the FSA Guidelines, and describes practical measures to be taken, such as “required actions for a financial institution.” It appears that an awareness has been brought to FSA regarding the FATF’s comments saying that the preparation of supervisory guidelines is necessary.

A prompt response must be taken on the premise of an analysis of the impact on each firm after these actions taken by the regulatory authorities, on account of “Deadline set for financial institutions to upgrade their risk management systems in line with the requirements set forth in the Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism,” announced by FSA in May 2021. This announcement suggests that the FSA has responded to the FATF’s comments by a request of completion of control framework establishment, i.e., compliance with the FSA Guidelines, by the end of March 2024.

It is worth noting that, with regard to establishment of a control framework, a steady execution plan with formulation of action plan and appropriate task management is required. In other words, the interpretation that “the completion of action plan is extended to the end of March 2024” without immediate action is not acceptable.

(2) Deepening the knowledge of anti-money laundering and counter-terrorist financing, understanding relevant risks across the firm, and further contributing to an enterprise-wide risk assessment report

Throughout the MER, it repeatedly says that most financial institutions have a limited understanding of their ML/TF risks. That is to say, such limited understanding of all applicable risks directly impacts the execution of the RBA by financial institutions, which clearly indicates that the FATF places the understanding of ML/TF risks as a fundamental premise.

Therefore, financial institutions need to further deepen their understanding of ML/TF risks. While there are many aspects to be considered in this matter, this flash report addresses (1) consideration from the perspective of supervisory authorities and (2) preparation of external reporting.

With respect to (1) above, in order to gain an understanding of “one’s own” ML/TF risks, each specific event shall be considered, e.g., through an analysis of suspicious transaction reporting. As per above-mentioned “Action Plan for Anti-Money Laundering and Combating Terrorist Financing and Proliferation Financing,” the “National Risk Assessment” will be updated by the end of 2021 while, by the end of autumn 2022, the FSA Guidelines are to be updated to bring risk awareness into the financial sector and to urge an adequate risk assessment. Leveraging these documents can lead to a better understanding of ML/TF risks. As to (2), the understanding of ML/TF risks must be evident externally. Financial institutions must ensure adequate preparation for any strengthened inspections by the FSA in an ongoing manner. The Action Plan says the FSA should “strengthen

supervisory inspection through risk-based approach.” In that sense, the FSA says, in its FY2021 Financial Administration Policy, as per the result of FATF’s Fourth Round MER of Japan, inspection and supervision will be strengthened through sufficient inspection personnel and by using a risk-based approach that affords top priority to business operators that pose the greatest risk. This approach is believed to be a response to the FATF comments which question the effectiveness of supervision. Additionally, considering the FATF’s comment saying that effective and deterrent sanctions have not been implemented, it is expected that future inspections and supervision over financial institutions will be more severe. To be able to present externally under such situation, it is critical that the risk assessment report should be updated to deepen the understanding of ML/TF risks.

(3) Enhancement of ongoing CDD and transaction monitoring

The “Action Plan for Anti-Money Laundering and Combating Terrorist Financing and Proliferation Finance” states that “Along with the aim to strengthen transaction monitoring, a deadline is set for the anti-money laundering and combating terrorist financing and proliferation finance measures taken on a risk-based approach, including ongoing customer due diligence, etc.” Given the specification in this statement, as well as the FATF comments indicating issues in both of the areas, among all the risk mitigation measures, ongoing CDD and transaction monitoring are believed to be of the utmost importance.

It is noted that, challenged by the FATF, due to the large number of existing accounts and self-declared information of beneficial owners by customers, neither the conventional ongoing CDD measures nor the conventional EDD measures is considered to be sufficient. As for transaction monitoring, it is commonly misunderstood to assume that an implementation of transaction monitoring system alone is sufficient. Rather, it is required to focus on customer attributes and transaction patterns while performing the monitoring, and to verify the effectiveness of the monitoring, e.g., testing the

false positive rate, as pointed out by the FATF.

(4) Summary

Carol Beaumier, Protiviti's Senior Managing Director of Financial Services in Asia, and a long-time leader in AML/CFT, commented: *"The FATF Mutual Evaluation Report recognizes that Japan has laid a good foundation for its AML/CFT regime, but indicates that there is more work to be done. This includes enhancing coordination among governmental bodies and law enforcement, further educating both traditional financial institutions and Designated Non-Financial Businesses and Professions (DNFBPs) on ML/TF risks and their related compliance obligations, setting deadlines for holding these organizations accountable for compliance; and stepping up its enforcement activities. So long as Japan remains subject to "enhanced follow-up" by FATF, the pressure will remain on the authorities and the financial services community to demonstrate continued strengthening of Japan's AML regime."*

With the publication of the MER, the "lull" following the on-site visit by the ICRG has come to an end. It is expected that the regulatory authorities will come up with measures with a top-down approach to overcome any challenges in the "Enhanced Follow-up" process. In fact, some measures have been set forth in the "Action Plan for Anti-Money Laundering and Combating Terrorist Financing and Proliferation Financing" announced by the MoF.

Agile countermeasures against money laundering and terrorist financing are required in response to the ever-changing risks and their corresponding global trends in an ongoing manner. The release of MER is a great starting point to observe the regulatory trends. It is believed that the current measures shall be promptly updated and continuously enhanced on account of the points (1) ~ (3) above.

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