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Impact of legalization of digital currency paychecks

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Executive Summary

The Japanese government is currently moving toward lifting a ban on paying wages and salaries with digital currency. If it decides to do so, the move could dramatically reshape the financial service supply structure beyond just diversifying wage/salary payment modalities.

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Scope has expanded from foreign workers to all workers, from designated zones to whole country

The Japanese government is currently moving toward lifting a ban on paying wages and salaries with digital currency. Under current labor laws, the only means by which employers are permitted to pay wages and salaries to workers is direct deposit of currency (cash) into the recipient's account (bank or securities account). The government is looking into easing this restriction.

This deregulation initiative dates back to August 2015, when the Regulatory Reform Promotion Council took up the issue in response to a proposal by private companies seeking regulatory relief to facilitate payment of wages to underbanked foreign workers. Subsequently, the Council on National Strategic Special Zones also began working on the issue in response to similar proposals by the city of Fukuoka and the Tokyo Metropolitan Government.

The initial proposals to ease restrictions on payment of wages/salaries were respectively limited to foreign workers and designated geographic areas. Recently, however, the idea has been broadened to encompass all workers throughout Japan. It has been incorporated into the government's national growth strategy and is on the agenda of the Government-Industry Cooperation Council (a forum where the national growth strategy's highest-priority themes are intensively discussed). One factor behind the proposal being broadened was strong resistance within the government to rewriting fundamental labor policy rules on employee compensation for a subset of workers or selected geographic areas only. Another likely contributing factor is that the government as a whole is promoting cashless payments and FinTech as policy priorities.

As used herein, "digital currency" means "a balance in an account provided by a funds transfer service provider." As defined in the Payment Services Act, "funds transfer services" refers to intermediation of currency payments of up to ¥1 million per transaction by a non-bank entity. There are currently 64 funds transfer service providers registered in Japan. Their services vary widely among providers. The discussion that follows mainly pertains to funds transfer service providers with mobile payment apps, such as LINE Pay and pring.

What should banks make of proposed deregulation?

In retail banking, banks are said to place utmost priority on being their customers' paycheck depository. Most banks presumably feel threatened by prospective legalization of direct deposit of paychecks into accounts with funds transfer service providers (mobile app accounts) out of fear that they will be supplanted as customers' paycheck depository. In banks' mind, it is assumed that "being supplanted" means losing deposits and/or losing a point of contact with customers. Let's examine these two concerns.

First, if someone's paycheck is direct-deposited into a mobile app account (wallet), the recipient can go shopping, pay bills and send remittances without having any interaction with a bank or even being aware of banks' existence. From such a perspective, money would certainly appear to be flowing out of banks by circumventing customers' bank accounts.

However, banks would not necessarily experience an outflux of deposits. Behind the scenes, the act of receiving paychecks in a mobile wallet, paying for purchases by scanning a QR code or barcode or remitting funds to friends or family always involves a payment routed through a funds transfer service provider's bank account. From the standpoint of the banking system as a whole, nothing changes except the name on the bank account involved: the account is in the name of a funds transfer service provider instead of the mobile app user. No money flows out of the banking system. Individual banks should be able to rectify any losses of retail deposits by partnering with funds transfer service providers as deposit account providers.

Second, losing a point of contact with customers could definitely be problematic for banks that have successfully created revenue streams by proactively marketing loans, investment trusts, insurance and other products or services to customers based on direct-deposit account information.

In actuality, however, few banks are able to utilize day-to-day direct-deposit account activity as actionable information for marketing purposes. Most banks seem to be struggling with how to translate account information into effective action. While direct-deposit accounts are important for banks, they only provide information on who is receiving how much income. Banks by themselves do not have access to information directly convertible into marketing pitches, such as information on their customers' spending preferences or life events.

In contrast, funds transfer service providers, being in closer proximity to their users, should be able to better gather and analyze nonfinancial information that can offer insights into users' financial behavior. Banks should explore how they can expand their core lending and payment services businesses by partnering with funds transfer service providers to gain access to the information that the funds transfer providers possess.

Funds transfer service providers also stand to benefit greatly from partnering with banks and other incumbent financial institutions. If many workers start having their paychecks direct-deposited into mobile wallets in the wake of deregulation, the amount of money flowing into mobile wallet accounts would likely increase sharply. However, such an increase would be of no benefit to funds transfer service providers in and of itself. The crucial issue for funds transfer service providers is how to get users to move money out of their accounts.

Funds transfer service providers are legally required to fully safeguard assets in their custody. They accordingly cannot lend out customer funds or use them as working capital. Consequently, if customers have their paychecks direct-deposited into their mobile wallets and then leave funds sitting idle in their accounts, the funds transfer service provider would likely end up incurring increased custodial costs, particularly in today's zero interest-rate environment. The one situation that funds transfer service providers presumably want to avoid at all costs is users who simply let funds accumulate in their accounts.

To address this problem, funds transfer service providers have so far been placing priority on expanding their merchant networks in the aim of incentivizing users to spend money. Once direct-depositing of paychecks into mobile wallets becomes legal, funds transfer service providers may have to step up efforts to encourage financial behaviors such as saving, investing, borrowing and insuring in addition to consumption. In other words, partnering with banks and other incumbent financial institutions is a strategic imperative for funds transfer service providers.

The topics discussed above have not yet attracted much attention, perhaps because mobile payments themselves are still proliferating. However, it goes without saying that payments of wages and salaries, the primary source of individuals' money, constitute a huge market at over ¥240 trillion per year[1]. The proposed deregulation of wage/salary payments has the potential to substantially change the financial service supply structure. Existing financial institution, as a provider of financial functions, and services and funds transfer servicers, as a provider of user interface, are expected to accelerate their specialization and cooperation. The world should witness such change unfold soon.

NOTE

1) According to National Tax Agency survey data on private-sector employee compensation, private business establishments paid total wages and salaries of ¥215.7 trillion in 2017. Additionally, the Ministry of Finance reported on its website that public-sector personnel expenses (mainly national and local government employees' salaries) totaled ¥26.8 trillion in FY2018.

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