NRI

lakyara vol.305

Is Japan on the right track toward legalizing digital currency paychecks?

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15.August.2019

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Executive Summary

In the government's 2019 growth strategy, a deregulatory initiative to legalize use of digital currencies to pay wages and salaries has made major strides since last year. In designing the forthcoming regulatory framework in detail, the government needs to set pragmatic rules aligned with actual practices.

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Government aims to legalize digital currency paychecks in FY2019

On June 21, the Council on Investments for the Future released an update on Japan's national growth strategy. The update contained a lot of information on important initiatives in the financial sector. It included legalization of digital currency as a medium for paying wages and salaries or, in other words, deregulation that would permit employers to pay wages and salaries into accounts offered by funds transfer services. Substantial progress appears to have been made toward legalizing digital currency paychecks[1].

The growth strategy update states that the government is conferring with business and labor groups in the aim of passing legislation allowing wages and salaries to be paid into funds transfer services' accounts as early as possible in the current fiscal year, provided that some safeguard (e.g., insurance coverage) is deployed to fully protect workers against losses in the event of a funds transfer service provider's insolvency. The most notable point is the explicit deadline of FY2019. By comparison, the Council on Investments for the Future's 2018 strategy merely said that the government would explore the possibility of legalizing digital currency paychecks. Major strides have been made since then.

Another key point is that legalization of digital currency paychecks is contingent on workers being protected against losses due to funds transfer service providers' insolvency. Under the Payment Services Act, funds transfer service providers are required to have security arrangements that cover at least the total amount of funds in customer accounts. If a funds transfer service provider were to go bankrupt, its security arrangement is supposed to fully refund customers' account balances. Given such security arrangements, a new safeguard against customer losses due to insolvency seems unnecessary.

NOTE
1) For background, see http://fis.nri.co.jp/~/media/Files/publication/kinyu-itf/en/2019/lakyaravol300.pdf.

Depending on what type of security arrangement is used, however, there is a non-negligible risk of not enough funds being available to fully pay off all customers (workers) in the event of insolvency as explained below. This risk is presumably why digital currency paychecks' legalization is contingent on customers being protected against losses by insurance or another such safeguard.

How necessary is a new safeguard?

Given workers' inarguable right to receive their wages and the obvious need for reliable payment modalities, a basic policy of making sure that workers are paid their wages even when a payment intermediary goes bankrupt is a good idea.

That said, the government needs to take a hard look at whether adding a new safeguard in the form of, say, insurance is the optimal way to implement such a policy.

The specifics of how workers will be protected against losses are still unclear at the time of this writing (late June 2019), but the government will presumably require funds transfer service providers to either pay premiums into a newly established insurance fund (joint responsibility) or purchase insurance coverage individually (individual responsibility).

The first option seems to have too many drawbacks to be feasible. First, with no funds transfer service provider having ever gone bankrupt so far, the data required to rationally set insurance premiums (e.g., probability of bankruptcy, loss given bankruptcy) are lacking. Second, whether the insurance fund is sufficiently funded can only be known after a bankruptcy has occurred. In other words, the joint-responsibility approach may impose excessive regulatory costs (insurance premiums) on funds transfer service providers. In addition, it may not even fulfill its intended purpose to ensure that workers are reliably paid if the insurance fund turns out to be underfunded.

Accordingly, the individual-responsibility option seems preferable from a pragmatic standpoint. If this option is chosen, utilizing existing safeguards may make more sense than designing new ones[2].

Under the current Payment Services Act, funds transfer service providers have three options in terms of available security arrangements. First, they can keep

2) The discussion in this paper is based on the existing regulatory framework for funds transfer services. The government is leaning towards revising this framework according to the discussion at the Financial System Council's Financial System Study Group. While the specifics have yet to be disclosed, the revision may resolve the security problems discussed herein. The Financial System Study Group presented a draft report on its discussions at its June 10 meeting.

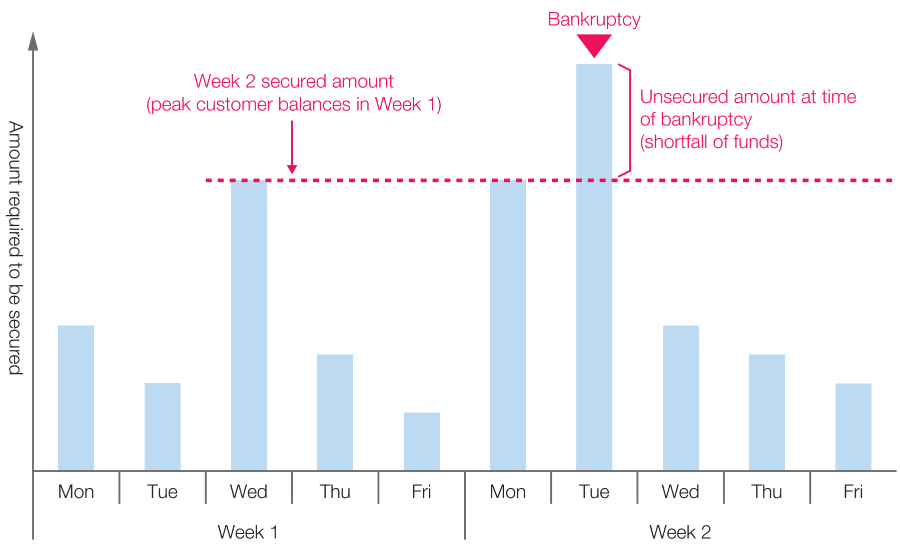
cash reserves on deposit with the Ministry of Justice’s Bureau of Legal Affairs. Second, they can enter into a security agreement with a financial institution. Third, they can enter into a trust agreement with a trust company. The first two options are not failsafe, meaning they may not fully cover the total amount owed to customers in the event of bankruptcy. With the first two options, funds transfer service providers must update their secured amount every week to at least the maximum amount of customer account balances during the week but they have until the end of the following week to do so. Their liabilities owed to customers at the time of bankruptcy consequently may not be fully covered (see graph below). With the third option, by contrast, the secured amount must be updated daily by the end of the next business day, minimizing the time lag involved.

Based on such a comparison, use of trust agreements with minimal time lags appears to be the best option, but trust agreements are reportedly not used much in actuality[3]. If so, the funds transfer service and trust industries should find out what is deterring use of trusts and attempt to fix the problem themselves. If they are unable to fully do so, whatever remains of the problem should be addressed with appropriate regulations.

3) According to the minutes of the Financial System Council's Financial System Study Group's March 4, 2019, meeting.

Additionally, there may be a better way to implement security agreements with financial institutions (the second option) that currently entail what are seen

Exhibit: Illustration of unsecured liabilities to customers due to time lag



Source: NRI, based on presentation materials prepared by Financial System Council’s Financial System Study Group (March 4, 2019) as unavoidable lags between secured-amount updates and the timing of any bankruptcy. Wage and salary payments fundamentally involve three questions: who, when and how much to pay. As such, they are predictable because employers can provide this information to funds transfer service providers in advance (if not, they would not be able to pay wages/salaries to individual employees). In short, funds transfer service providers should be able to quite accurately forecast the amount of wages and salaries that needs to be covered by their security arrangements. Setting a minimum security requirement based on such a forecast may be able to prevent unsecured liabilities to customers in the event of bankruptcy.

There are many other even better ideas on ensuring the reliable payment of wages to workers based on actual practices. It could be concerning to read that the government is discussing deregulation of digital currency paychecks only with “business and labor groups”. Funds transfer service providers and even financial institutions and trust company also should have seats at the table as the details of prospective deregulatory legislation are finalized. Their involvement should lead to a regulatory framework better aligned with actual practices. More developments are expected and will be closely monitored.

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