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Overview of pending legalization of digital currency paychecks and future challenges

Katsutoshi Takehana

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Nomura Research Institute, Ltd.

Executive Summary

Katsutoshi Takehana
Senior Researcher
Financial Market & Digital Business Research Department

Since January, discussions on lifting the ban on direct-depositing of wages/salaries into mobile payment accounts have been rapidly progressing. If this deregulation comes to fruition, it should bring a lot of benefits for users. From a financial system standpoint, however, money transmitters' business model may need a rethink.

Move to legalize digital currency paychecks has gained momentum in 2021

Regulatory discussions on lifting Japan's ban on digital currency paychecks (i.e., payment of wages/salaries into mobile payment accounts offered by money transmitters) have shifted into high gear in 2021. Under the current Labor Standards Act and its enforcement regulations, the only means by which employers are permitted to pay wages/salaries is cash and direct-deposit into the recipient's bank or brokerage account. The deregulation now being discussed would allow paychecks to be direct-deposited into mobile payment accounts as well.

This deregulatory initiative dates back to an August 2015 proposal by the Regulatory Reform Promotion Council to facilitate payment of wages to foreigners living and working in Japan. The proposal became much more of a priority after it was included in the government's national growth strategy unveiled in June 2018. Digital currency paychecks had initially been promoted primarily to facilitate greater utilization of foreign workers. They were seen as an accommodation for a small subset of workers. Since June 2018, however, digital currency paychecks have been reframed as a pillar of a key policy promoting cashless payments and FinTech. They are now a deregulatory priority with nationwide scope encompassing the entire labor force.

Money transmitters are non-bank operators of funds transfer services. In Japan they are regulated under the Payment Services Act. They most notably include providers of QR-code payment services like PayPay and LINE Pay. According to a Payments Japan Association survey[1], 30 million or one in four Japanese make QR-code payments at least once a month. Direct-depositing of paychecks via

NOTE
1) Payments Japan Association's survey on QR-code payment usage published on December 25, 2020.

such payment rails embedded in consumers' daily routines would save consumers the trouble of having to add money to their cashless payment account whenever they go shopping. In fact, in a Japan Fair Trade Commission (JFTC) survey[2], 40% of users of money transmitters' QR-code payment services expressed interest in having their paychecks deposited into their mobile payment account, suggesting strong latent demand for digital currency paychecks. More importantly, a mass rerouting of paychecks, the source of individuals' money, from bank accounts to mobile payment accounts should give rise to many new services.

2) JFTC survey report on QR-code cashless payments (April 21, 2020).

Companies are already preparing for prospective legalization of digital currency paychecks. For example, Yahoo Japan is using PayPay to pay work-from-home allowances (not wages/salaries) to employees[3] and au Payment has announced a new alliance to develop a wage/salary payment service[4].

3) Per a Yahoo Japan press release dated February 18, 2021.
4) Per an au Payment press release dated January 18, 2021.

MHLW has proposed worker protections as prerequisite to lifting ban

One big question since early in discussions of legalizing digital currency paychecks is what worker protections would be needed to allow paychecks to be deposited in mobile payment accounts. The consensus was that a second layer of regulation would be required in addition to regulation under the Payment Services Act because, from a user protection standpoint, money transmitters' services were seen as riskier than banks, which offer protections such as deposit insurance.

The Ministry of Health, Labour and Welfare (MHLW) clarified its position on this question in an April 19 presentation to the Labour Policy Council. According to the presentation, money transmitters would have to be approved by the Minister of HLW to accept direct deposits of wages/salaries. To obtain such approval, they would have to (1) have controls in place to reliably safeguard assets and swiftly refund account balances to workers in the event of bankruptcy, (2) indemnify users against losses due to unauthorized withdrawals from their accounts, (3) allow users to withdraw cash from their accounts free of charge at least once a month, (4) report on their financial condition and the status of their operations to the Minister of HLW and (5) otherwise have a good public reputation[5].

5) Examples of indicia of a good public reputation cited by the MHLW include having never previously been subject to disciplinary action under the Payment Services Act.

Regarding the first of these requirements, money transmitters already have a duty under the Payment Services Act to safeguard users' assets by holding minimum cash reserves in trust equivalent to users' aggregate account balances.

The MHLW, however, considered this duty to be inadequate protection for two reasons. First, the process of refunding money from such trusts to users amid bankruptcy tends to involve considerable delays. Second, depending on the bankruptcy's timing, the cash reserves held in trust may be insufficient to refund users' entire account balances as a result of a time lag between when the required amount of reserves was last calculated and when the reserves were frozen to protect account holders. To address these two issues, the MHLW is proposing that money transmitters must be doubly protected by both an insurer and a guarantor to ensure they can swiftly issue sufficient refunds even if bankrupt. While the MHLW's proposal is commendable from a worker protection standpoint, it will likely impose significant costs on money transmitters.

Money transmitters' business model may be called into question in future

At the time of this writing (late April), the Labour Policy Council does not appear to have reached a decision yet. If it hypothetically adopts the MHLW's proposal without major changes, how quickly would digital currency paychecks gain traction and what types of challenges would likely arise?

First, even once the requisite institutional arrangements have been put in place, direct-depositing of paychecks into mobile payment accounts will likely take a while to become widespread, largely because companies will need time and incur considerable costs to modify their payroll processes and IT systems. The rate of adoption will hinge on how many companies decide at an early stage that the benefits of adopting digital currency paychecks outweigh the costs. In actuality, however, the early adopters will likely be limited to companies that employ foreigners, money transmitters themselves and companies in adjacent businesses.

Second, if mobile payment accounts do become widely used for direct-depositing of paychecks, the pre-existing issue of money sitting dormant in mobile payment accounts will likely become an even bigger problem, forcing regulators to make changes. Currently, money transmitters are confined to the remittance business. They are prohibited from accepting deposits, mainly out of concern that they would run afoul of deposit-taking regulations in the Act Regulating the Receipt of Capital Contributions, Receipt of Deposits and Interest Rates (the Capital Contribution Act) if they were to hold customer funds unrelated to remittances. In 2020, the Payment Services Act was amended to add regulations on dormant account balances, but the new regulations are undeniably ambiguous as to how much dormant balances are permissible. If mobile payment accounts come to be used for direct-depositing of paychecks, dormant account balances would likely increase from their current level, leading to a widening divergence between official policy and actual practice.

When the Financial System Council was discussing the Payment Services Act prior to its latest amendment, I proposed that the authorities consider narrow banks (banks that specialize in funds transfer services and deposit taking but do not lend or otherwise invest their deposits) as a realistic solution to the quandary posed by dormant balances piling up in mobile payment accounts. I did so because I believe the gap between official policy and actual practice will eventually become too pronounced to ignore.

To date, regulators have continued to hew to the official policy line, particularly in relation to the Capital Contribution Act. Meanwhile, actual practice has been modified to conform with official policy. From a long-term perspective, however, the official policy stance will likely have to change. The upcoming deregulation could spark much discussion toward such change.

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Inquiries to : Financial Market & Digital Business Research Department
Nomura Research Institute, Ltd.
Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
E-mail : kyara@nri.co.jp

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