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vol.33 (10.March.2008)

Electronic claims: a Japanese financial innovation

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The Electronically Recorded Claims Act, enacted last June, is slated to take effect by December 2008. A financial innovation without precedent in the US or Europe, electronic claims are conducive to the development of new types of monetary claims and secondary markets for them. Among various potential uses, they could replace commercial bills, enhance negotiability of accounts receivable, and contribute to rationalization of loan administration.

Paperless settlement of securities and financial transactions is progressively taking root in Japan's financial and capital markets. Paperless settlement was first adopted in the commercial paper market, followed by the corporate bond market. Next up, listed companies' share certificates are scheduled to be replaced with an electronic book-entry system effective from January 2009.

Against such a backdrop, Japan's Diet (parliament) enacted the Electronically Recorded Claims Act in June 2007. A financial innovation without precedent in the US or Europe[1)], electronic claims will be originated and transferred between parties via an electronic book-entry system maintained by electronic claims registry institutions. As such, they are conducive to the development of new types of monetary claims and secondary markets for them. The Japanese government originally began studying electronic claims as a means of facilitating financing for SMEs (small and medium-sized enterprises) as part of its e-Japan Priority Policy Program. The study was subsequently broadened to encompass e-commerce, syndicated loans, and linkage to CMSs[2)], in addition to the potential to replace commercial bills (including promissory notes and drafts; ditto below) and enhance the negotiability of accounts receivable. The system that was ultimately adopted was designed with sufficient flexibility to accommodate all of these uses[3)].

Below, we first discuss electronic claims as a substitute for commercial bills and a means of enhancing the negotiability of accounts receivable, two uses considered to be integrally connected with SME finance. We then discuss electronic claims' utility vis-à-vis rationalization of loan administration, an application we consider to be institutionally feasible.

Electronic claims as a substitute for bills

In Japan, commercial bills have historically been widely used among companies. Since the 1980s, however, large companies have been discontinuing use of bills, which entail storage and delivery costs and payment of stamp taxes, in conjunction with rationalization of their back office operations. Large, highly creditworthy corporations in particular have scaled down their use of bills in favor of consolidated payments. These companies' subcontractors are able to receive cash payments sooner by utilizing consolidated payment services offered by the large corporations' banks instead of having their own banks discount bills received in payment[4)]. By 2006, bill redemptions had fallen to ¥478 trillion, one-tenth of their 1990 peak.

Consolidated payment services are generally not available to SMEs and other companies on the lower end of the creditworthiness scale. Such companies consequently still make payments with bills, putting them behind the curve in terms of rationalizing the processing of incoming and outgoing payments. For example, the annual cost of stamp taxes on bills alone is estimated at some ¥240 billion on a nationwide basis[5)]. Additionally, at the societal level, substantial fixed costs are incurred for safekeeping of bills at companies that use them and for maintenance of bill payment and redemption infrastructure at financial institutions.

Legally, electronic claims can coexist with bills, given that they are a new type of monetary claim and the Bills of Exchange Act has not been repealed. From the standpoint of infrastructure costs, however, it would be efficient to replace paper bills with electronic claims. Such a transition from paper to paperless is of course likely to meet resistance from many businesses accustomed to using bills. To overcome such resistance, financial institutions should adequately explain to customers the benefits of rationalization and offer a variety of payment modalities (eg, ATM, mobile banking, paper forms for origination/transfer of claims). Although such accommodations are extra work, financial institutions stand to benefit by gaining access to information on customers' accounts payable/receivable from the time of the claims' inception. Electronic claims also offer financial institutions the potential to cultivate closer relationships with SME customers by rendering their credit status more readily ascertainable.

Enhanced negotiability of accounts receivable

Bills are not the only means by which companies receive payment for products and services. Analysis of the balance sheets of SMEs with less than ¥100mn in paid-in capital and their balances of discounted bills receivable reveals that these SMEs receive bills in payment for about a quarter of their sales. The remaining three quarters are booked as accounts receivable. These accounts receivable are nominative claims under Japan's Civil Code and can be originated only by agreement between the parties to a transaction. Accounts receivable consequently lack transparency from the standpoint of third parties, making them less suitable than bills as a financing instrument. One drawback of nominative claims is that they are generally not assignable without the debtor's consent. Creditors tend to be reluctant to request such consent for fear of inviting speculation that they are hard up for cash. Additionally, it is reportedly not uncommon for nominative claims to be subject to a nonassignability clause. Even if a nominative claim is assignable, the cost and time required for a financial institution to confirm that it has not already been assigned cannot be overlooked.

Electronic claims resolve these drawbacks by enabling third parties to readily confirm a claim's existence and ascertain whether it has already been assigned[6). Additionally, if financing secured by accounts receivable becomes as prevalent as bill discounting is today, SMEs will benefit from diversification of financing options. For financial and capital markets, electronic claims will enable SME credit risk to be traded as a new asset class. In addition to being traded individually, electronic claims can also be aggregated and securitized.

Given the large numbers of companies and financial institutions involved, a consensus regarding replacement of bills with electronic claims or negotiability of accounts receivable may not be reached for some time. Additionally, while demand for electronic claims as a substitute for bills is likely to be steady, its growth prospects are limited. In terms of negotiability of accounts receivable, treatment of prohibitions against claims' assignment will depend on the electronic claims registry institutions' business policies. The demand outlook is therefore uncertain. In sum, if electronic claims are used only to facilitate financing for SMEs, their market's growth prospects are limited. The economic feasibility of establishing and operating specialized electronic claims registry institutions is therefore a major question mark[7)].

Applicability to loans

In addition to SME finance, electronic claims could conceivably also be used to rationalize loan administration. The information that is recorded when an electronic claim is originated consists of essential information and optional information. The former is information required to create a valid claim, including the claim's face value and payment due date(s), the creditor and debtor's names and addresses, and the claim registration number and recordation date. Optional information could include stipulations regarding payment method (including installment payment amounts, if any), interest charges, late charges or penalties, acceleration of payment obligations in the event of default, and/or dispute resolution methods.

If lenders utilize such optional data entry fields, electronic claims should help them service various types of loans that currently use standard loan agreements, such as syndicated corporate loans involving multiple lenders and residential mortgage loans that require long-term retention of loan documents and repayment records. Centralized servicing of loans through utilization of electronic claims should result in substantial administrative cost savings[8].

From such standpoint, electronic claims have the potential to revolutionize business processes in various financial businesses. The government is now fleshing out the Electronically Recorded Claims Act by drafting ancillary ordinances and a Cabinet Order that will set an effective date no later than December 2008. How electronic claims are used in practice may depend on such legislation's content as well as users' needs. Developments leading up to the debut of this financial innovation unique to Japan bear close watching.

Note

1) Korea is promoting use of electronic accounts receivable claims and electronic bills of exchange.

2) Cash Management Systems

3) For more information on anticipated uses, see the relevant METI working group's second report (May 2007), interim report (February 2007), Electronic Claims Program (2006), and Electronic Claims Project (2005).

4) The Subcontracting Act gives subcontractors the option of being paid with bills if they so desire. It is estimated that bills still account for roughly 20% of payments to subcontractors.

5) The stamp tax on bills averages 3 basis points (0.03%). The ¥240bn estimate is based on annual bill issuance, including loans against bills, of ¥800 trillion (Tetsuya Isozaki & Associates).

6) Nonassignability clauses are legally permitted but electronic claims registry institutions have the right to prohibit such clauses as a matter of policy.

7) Registry institutions must be licensed by the competent ministry and are prohibited from engaging in businesses other than the electronic claims registry business and other operations incidental thereto.

8) Such administrative rationalization is even more significant if reduction of risk (eg, of misappropriation of loan documents) is taken into account.

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