NRI Dream up the future.

lakyara

2009

Kyara, which means “precious” in ancient Japanese,
is an aromatic resin regarded as the highest quality of all agarwood.
“lakyara [la-kǽla]” aims to deliver the same quality as Kyara together with
NRI’s endeavour for continuous excellence and innovation to provide
the most advanced and up-to-date information to our readers worldwide.

vol.58 (10.August.2009)

Electronic claims' potential to revolutionize finance

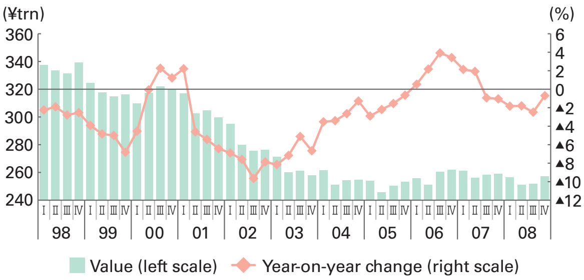
Nomura Research Institute, Ltd.

Electronic monetary claims, an innovation born of the fusion of legal and IT infrastructures, have the potential to drastically change financial institutions' lending businesses.
Development of new economic infrastructure is a key imperative for 21st century Japan. The extent to which such innovation benefits society hinges upon its wise application and society's willingness to cooperate.

The long-heralded advent of electronic monetary claims has finally arrived[1]. The Japan Electronic Monetary Claim Organization (JEMCO), established by Bank of Tokyo-Mitsubishi UFJ, commenced operations in July[2]. JEMCO's service offerings mainly revolve around 0settlement of electronic drafts[3] and infrastructure development in the syndicated loan market. Other banks also plan to launch electronic monetary claim recording institutions. Sumitomo Mitsui Banking Corporation and Mizuho Bank plan to do so in the near future[4], while the Japanese Bankers Association is preparing to establish one by the first half of 2012. In addition to establishing such claims recording institutions, banks are also looking at actively using electronic claims[5]. These developments are momentously significant and hold great promise as the emergence of new financial infrastructure for the 21st century.

The official decision to institutionalize electronic monetary claims dates back to the government's 2003 e-Japan Strategy II. After six years of extensive debate and preparations, the Electronically Recorded Monetary Claims Act took effect in December 2008. While electronic claims are expected to fulfill various functions, their primary purpose is to facilitate financing for businesses, particularly small and medium-sized enterprises (SMEs). Many factors can be cited as impediments to SME finance[6], but from the standpoint of the Electronically Recorded Monetary Claims Act's legislative intent[7], helping to facilitate SME finance through proactive utilization of electronic claims is considered a duty of the financial institutions that are the biggest players in intermediated finance (see exhibit).

Exhibits. Financial institutions' outstanding loans to SMEs



Source: 2009 White Paper on Small and Medium Enterprises in Japan

How will electronic claims affect bank lending?

In terms of financial institutions' electronic claims strategy, one approach is to first set up and commence operation of a claims recording institution. However, this approach entails a sizable initial investment[8] and operating costs. Investments in claims recording institutions are consequently likely to take a long time to recoup. Rather than focusing solely on establishing claims recording institutions, financial institutions should place more priority on utilizing electronic claims to expand their businesses and improve operating efficiency.

First, in terms of business expansion, assignment of electronic claims could be used as an alternative means of discounting drafts and extending credit secured by drafts. These businesses' growth potential would be enhanced if trade receivables are progressively converted to electronic claims. Additionally, plans are already afoot to utilize electronic claims for highly liquid syndicated loans and factoring, which is gaining prevalence as a means of monetizing trade receivables. There are also numerous other ways in which electronic claims could facilitate lending, including utilization in consumer lending (e.g., home mortgages) and asset-based lending, which has promising growth prospects by virtue of its compatibility with electronic claims. Moreover, electronic claims are expected to be highly negotiable like drafts. Highly reliable electronic claims could therefore become nearly indistinguishable from electronic money[9].

In terms of improving operating efficiency, financial institutions have the potential to substantially reduce their clerical costs by converting their own loan receivables to electronic claims. For example, conversion of drafts receivable to electronic claims would obviate the need for draft custody operations. If financial institutions pursue paperless lending through such means as offering online loan applications and storing all loan documents on servers, they undoubtedly could substantially reduce their physical costs also. They may even be able to drastically rationalize back-office processes for home mortgages involving voluminous paperwork and syndicated loans with complex contract management requirements.

Of course, adopting a new institutional framework like electronic claims inevitably entails adaptations. For example, to apply for electronic recordation on behalf of customers, financial institutions must modify their computer systems to submit applications to claims recording institutions. Additionally, electronic claims' advent increases the types of monetary claims in use[10]. This increase is likely to have a significant impact on financial institutions' lending practices by requiring system modifications (e.g., addition or revision of accounts used for journal entries) and revision of contractual provisions (e.g., in loan agreements, banking transaction agreements).

Nonetheless, if financial institutions can reform their overall lending operations by adroitly utilizing electronic claims, this reform has the potential to radically change back-office processes. In the corporate lending market in particular, it would not be surprising if some financial institutions convert all their loan receivables to electronic claims within a few years.

Prerequisites for future growth

For electronic claims to grow in prevalence, the first requirement is obviously growth in origination and trading of electronic claims. Toward this end, it is desirable for highly creditworthy borrowers such as the national government, municipalities, and large corporations to take the lead in utilizing electronic claims. Financial institutions and claims recording institutions will likely also need to conduct educational activities and promote electronic claims' widespread use. Incentives for origination and/or acceptance of electronic claims throughout society will also likely be necessary.

Another prerequisite for market growth is cost savings. To issue a ¥20 million draft, a company currently has to pay a stamp tax of ¥4,000 plus a document preparation fee. Companies also pay service charges of several hundred yen for electronic funds transfers in payment of accounts receivable. Fees for electronic claims transactions must be set lower than these existing charges.

Meanwhile, financial institutions will unavoidably incur duplicative administrative costs unless the practice of issuing drafts is completely abandoned. While there are pros and cons to de facto abandonment of the draft system that has been in use for a century, these duplicative costs will end up being passed on to users. During deliberations on the Electronically Recorded Monetary Claims Act, coexistence of electronic claims and existing practices was said to be advantageous for users[11], but perpetuation of the practice of issuing drafts is likely to eventually be called into question.

Electronic monetary claims are merely an infrastructural means to achieve certain objectives, most notably facilitation of SME finance. Until electronic claims become integrated into companies and consumers' economic activities, society as a whole must cooperatively embrace electronic claims with a strong willingness to utilize them. Meanwhile, financial institutions should give serious thought to what types of new financial services to offer using the tool of electronic claims. In the aim of contributing to society, however modestly, we at NRI also intend to facilitate the growth of electronic claims as highly convenient societal infrastructure integral to both industry and finance.

Note

1) For background information, see lakyara No. 33 (March 2008), "Electronic claims: a Japanese financial innovation."

2) At the time of this writing, JEMCO was scheduled to commence operations in late July according to Bank of Tokyo-Mitsubishi UFJ.

3) In Japan, companies frequently issue postdated drafts (*tegata*) in payment of trade payables and other obligations.

4) SMBC and Mizuho Bank's electronic claims recording institutions are scheduled to commence operations in the second half of fiscal 2009 and first half of fiscal 2010, respectively.

5) For example, Hiroshima Bank formed a study group of vendors, attorneys, and other concerned parties to promote local economic revitalization and Bank of Tokyo-Mitsubishi UFJ has issued research reports in collaboration with the city of Yokohama.

6) One indisputable impediment to SME finance is that large corporations have reduced issuance of drafts to cut costs (e.g., stamp taxes).

7) In the House of Councilors, passage of the Electronically Recorded Monetary Claims Act was accompanied by a resolution urging efforts to establish adequate financial infrastructure conducive to SME financing in particular.

8) The minimum paid-in capital requirement for claims recording institutions is ¥500 million.

9) For example, a conference jointly sponsored by JEMCO and the city of Yokohama proposed using electronic claims for payment of obligations under public works contracts. The proposal's rationale was that if municipalities make construction progress payments with electronic claims pursuant to progress payment contracts, they would not have to arrange funding to do so and they would help improve the payee's liquidity position because the claims could be immediately converted to cash.

10) As one example, the aforementioned banking transaction agreement (Japan Bankers Association model form) lists "loans on drafts, discounting of drafts...." in Article 1 (Scope of Application). Verbiage covering electronically recorded loan receivables would presumably have to be added.

11) According to records of the Ministry of Economy, Trade and Industry's deliberations.

Author's Profile

Hiroyuki Miyakawa

Manager, System Consultant
Banking Business Promotion Department

E-mail : kyara@nri.co.jp

Inquiries to : Department of Financial Markets and Technology studies
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara