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1. The expected PSD II

The proposals of the EU Commission for a new version of the Payment Systems Directive (PSD II) and an interchange regulation has not been published yet (it is expected for July 24) but there are already many rumours about the changes it will bring.[1]

With respect to interchange fees, the Financial Times reported that the EU Commission plans to cap debit card interchange fees at 0.2% and credit card interchange fees at 0.3%. The FT also says that the regulatory treatment of commercial cards is still open.

The PSD II seems to imply more and stricter regulation such as:

- strong authentication for non-face-to-face transactions
- extension of the regulatory framework to include all mobile payments[2], online banking based e-payments (so called "overlay programs") and independent ATM service providers
- the exemption for limited networks is restricted
- surcharging by merchants is not allowed for card transactions that are covered by the interchange regulation[3]

Overall, the EU Commission seems to be determined to extend the scope of regulation and to make existing regulations more severe.

[1] See, for instance, Alex Barker, Card transaction fees to be capped under EU proposal, FT web edition, 16 July 2013. Jeremy Fleming: New mobile payment systems pose regulatory, security challenges, Published 11 July 2013, updated 12 July 2013, http://www.euractiv.com/special-report-payments-services/innovative-mobile-payments-pose-news-529224. Jeremy Fleming: EU's new payments directive to cap fees, ignite consumer debate, Published 08 July 2013, updated 09 July 2013, http://www.euractiv.com/special-report-payments-services/payment-services-proposal-cap-fee-news-529102

[2] In the PSD I, the following mobile payment services were exempted: payment transactions executed by means of any telecommunication, digital or IT device, where the goods or services purchased are delivered to and are to be used through a telecommunication, digital or IT device

[3] This may imply that commercial cards will remain outside the interchange regulation.

Our comment

In a way a cap of 0.2% for debit cards and 0.3% for credit cards is good news. After all, for a while it seemed likely that the Commission would ban interchange fees completely. So, in the end, the worst case scenario has not materialized. Now it will be interesting to see, how this will affect the card industry. The card market is a two-sided market and lower fees on the acquiring side may help expand card acceptance. This, in turn, may help issuers.[4]

The PSD II proposal will be published soon and the published document will provide an opportunity to comment the proposals of the EU Commission in more detail. However, what is currently discussed suggests that the regulatory train moves towards ever more regulation. Frankly, we fail to see a compelling reason why regulators are tightening the screws.

2. The ECB on e-money and virtual currencies: Does the regulator know the regulations?

In October 2012 the European Central Bank published a remarkable study on "Virtual Currency Schemes"[5]. At that time, the Bitcoin exchange rate was still stable (about 12 USD per Bitcoin). But only a little later, in the beginning of 2013, the Bitcoin rally started reaching its peak rate of 237 USD in April. This rally led to an intensive worldwide discussion about the nature, challenges and threats of virtual currencies. The ECB report includes two case studies of the virtual currencies Bitcoin and Linden Dollar (of the Second Life virtual community). Based on its findings, it proceeds to discuss the relevance of such private unregulated (at least at the time being) currency schemes for central banks.[6]

The ECB is not worried at the moment because the volume of virtual currencies is still low. Therefore it does not see them as a threat to financial stability. But the ECB notes that such virtual currencies could have a negative impact on the reputation of central banks.

[4] In the December 2012 edition of this newsletter, we pointed out that the much quoted study of the effects of interchange reductions in Spain shows that the interchange reduction may even have had positive effects for the card industry ("New study on the effects of mandatory decrease of interchange fees in Spain").
[5] ECB, Virtual Currency Schemes, October 2012
http://www.ecb.int/pub/pdf/other/virtualcurrencyschemes201210en.pdf
[6] It should be noted that the report is not published as a Working Paper or Occasional Paper under the names of specific authors. It is published as a report authored by the ECB/Eurosystem. As such it does it contain the usual disclaimer that can be typically found in reports of individual authors.

Moreover, the ECB points out that the high degree of anonymity of virtual currencies poses a challenge to public authorities because virtual currencies could be used as means of payment for illegal activities and money laundering.

Our Comment:

Digital currencies like Bitcoin are decentralized digital bearer instruments stored in an electronic device (PC, chip card etc.). Such instruments are not a new phenomenon. The first wave of pioneers of this digital cash-equivalent, like Mondex and DigiCash, entered the monetary world in the mid-90-ies. Unfortunately, they did not survive.[7] Similarly, the e-purses schemes that were meant to replace cash in the physical world did not gain much of the market and were discontinued in most European countries (except Germany where banks still ride an expensive, but almost dead horse called "GeldKarte").

In spite of the limited success of the early attempts to implement digital cash in the market, central banks and other oversight authorities in Europe introduced a wave of (premature) regulation of these digital currencies. In 2000 the first E-Money Directive (2000/46/EC) was passed – long before any relevance of these e-money products could be detected.[8]

Indeed, with the closure of most schemes, there was hardly anything that fell under the new regulation. But rather than having an empty regulatory box regulators started to widen the definition of e-money to include all kinds of other new payment instruments. Later on, this regulatory practice found its way into the definition of e-money in the second E-Money Directive in 2009 (2009/110/EC).

As a consequence, today most of the e-money schemes which fall under the scope of the e-money-regulation have nothing to do with genuine e-money in the sense of digital cash (digital bearer certificates).

Most of today's e-money consists of balances held in special "prepaid" accounts, centrally administered by the issuing institutions. These accounts are like limited purpose accounts comparable to a current account at a bank that has a restricted functionality. PayPal is the well-known market leader of this kind of e-money.

[7] The initial period of digital currencies is analysed in: Herausforderungen des bestehenden Geldsystems im Zuge seiner Digitalisierung – Chancen für Innovationen?, Forschungszentrum Karlsruhe, FZKA 6160, Karlsruhe 1998 www.itas.fzk.de/deu/Itaslit/krgo98a.pdf.
[8] See Krueger, Malte: E-money regulation in the EU, in: Robert Pringle and Matthew Robinson (eds.), E-Money and Payment Systems Review, London: Centralbanking 2002, 239-251.

So, in the EU, we have had regulations in place for genuine e-money and other prepaid products for more than 10 years. As far as we can see, most "virtual currencies" would simply be treated as "e-money" if they were issued in the EU. However, notwithstanding the existing regulations, the ECB Report makes a comparison between "E-Money" (regulated) and "Virtual Currencies" (not regulated). It identifies two types of virtual currency schemes,

- *closed schemes and*
- *schemes with a monetary inflow via currency exchanges (traditional exchange: currency versus virtual currency).*

In contrast to e-money, the unit of account of virtual currencies is an invented unit (like Bitcoins). Moreover, there is no guaranteed redeemability of virtual currency funds into traditional currency.

The analysis of the ECB is striking for a number of reasons:

First, it is remarkable to see that the ECB is using an outdated interpretation of e-money which not complying with the current e-money definition of the E-Money Directive and the regulation within the EU.

Second, no matter whether the EMD I (not relevant since 2009) is used or EMD II, the core characteristic of e-money has remained the same: issuance on receipt of funds (= prepaid). This implies that every virtual currency which is issued (not traded!) in exchange for traditional money is legally defined as e-money (if the other requirements are fulfilled too).

Thus, the equation "virtual currency = unregulated" applies only in special cases like Bitcoin. Otherwise, those currencies defined by the ECB as "virtual currencies", which are issued via an inflow of traditional currency, are subject to e-money regulation in the EU! Linden Dollars or Liberty Reserve Dollars (both "prepaid") would be subject to e-money-regulation if issued within the EU-jurisdiction. All of these schemes would have to be redeemable at par. This is a regulatory requirement (Article 11 of EMD II) and cannot be part of a definition or a criterion for categorization, as in the ECB report. (By the way, when the EMD I was drafted in 1999, the ECB itself insisted on this requirement).

Third, the report states that e-money is (in contrast to virtual currencies) always issued in units of account of existing legal tender currencies. This is also not correct. Regulated e-money can be issued in fantasy units but the exchange rate vis-à-vis the legal tender currencies must be fixed ("issuers issue electronic money at par value on the receipt of *funds", "issuers redeem, at any moment and at par value"). The denomination is not essential! The ECB is missing the point by stating: "lastly, the fact that the currency is denominated differently (i.e. not euro, US dollar, etc.) means that complete control of the virtual currency is given to its issuer, who governs the scheme and manages the supply of money at will."*[9]

Fourth, another criterion of categorization used by the ECB is the acceptance of the currency: only virtual or also real goods and services. A good or service is virtual, if it is offered within a virtual community and cannot be traded outside the community (ECB-definition). From a monetary and regulatory point of view the kind of goods and services which can be bought with a particular currency has no relevance, at all. Relevant could be the level of acceptance at third-parties (besides the issuer) whether in a virtual or real world.

So, as rule of thumb: if a virtual currency is prepaid, it is e-money with the regulatory requirement of redeemability at par value. Only non-prepaid currencies in closed systems (like Bitcoin or some in-game currencies) could be considered as non-regulated virtual currencies in the EU.

Central banks are monopolist providers of cash. So, they may be forgiven when they do not spend an awful lot of time observing and analyzing competitors. But central banks are also regulators and as such they should - at least after 10 years of experience - understand what they are regulating and what the regulations are.

3. German Competition Authority favours bi-lateral negotiations on card fees

The German Competition Authority (GCA) (Bundeskartellamt) has announced that it objects the setting of a uniform bank fee for ec cash / Girocard. Instead of a uniform fee, the GCA wants merchants and banks to negotiate the fees on a bi-lateral basis.[10] As it points out, in some cases, large merchants have already been able to negotiate fees. However, the GCA wants safeguards that such negotiations cannot be prohibited by scheme rules. Furthermore, it would like to give merchants the possibility to decline the cards of particular issuing banks.

[9] ECB (2012), p. 5.
[10] Bundeskartellamt: Wettbewerbliche Bedenken gegen electronic cash Kartenzahlsystems der Deutschen Kreditwirtschaft, Bonn, 28 May 2013 (http://www.bundeskartellamt.de/wDeutsch /aktuelles/presse/2013_05_28.php). See also the chapter on Germany in: OECD: Competition and Payment Systems. Policy Roundtables, 28 June 2012.

A second point important for the GCA is the possibility for merchants to apply a surcharge. Due to the intervention of the GCA, ec cash rules do not contain any surcharge prohibitions.

Finally; the GCA stresses the importance of ELV (the signature based card payment without guarantee). The GCA sees ELV as a system competing with ec cash and warns banks not to use technological changes as a means to make ELV impossible (or less competitive). In this respect, it explicitly mentions the replacement of bank account numbers and bank codes by card numbers or long notification periods ("5 days") before an ELV payment can be debited to the bank account of the card holder.

The banking associations have the opportunity to comment on the views of the GCA and to make proposals how to resolve the issues raised by the GCA.

Our Comment

In the member states of the EU, competition policy becomes more and more uniform. However, there still is room for national approaches. The current document published by the GCA is a case in point. The GCA sees bilateral negotiations as a way to deal with the problematic sides of multilateral interchange fees. With this position, it probably stands alone in the EU.

Why do other anti-trust watchdogs not promote bilateral negotiations? The reason is that such negotiations have severe disadvantages.

First, a merchant negotiating with a number of banks is not the same as, say, a merchant negotiating with a number of suppliers of vegetable oil. In the latter case, one supplier can substitute another. Thus, there is competition between these suppliers. However, the different banks offer access to their customers. They are not in competition – at least vis-à-vis the merchant on the other side of the negotiation table. So, the only way to sanction the behavior of a bank that demands high fees is to stop accepting the cards of this bank. This is precisely what the GCA wants. But this implies that card holders can no longer clearly distinguish where a card is accepted and where not. The power of the brand is diminished, and - we would add – the usefulness of the card for the card holder. If however, all cards must be accepted, how are merchants and banks supposed to find an agreement on fees?

The decision of the GCA also highlights the difficult situation of market players in the payment market. The EU Commission is pushing them ahead with its demand for European payment schemes such as SCT and SDD. Thus, banks and PSPs have to design schemes *reflecting the preferences of member states. In the case of SDD, this implies a system with long notification periods. However, the outcome may not please all of the national regulators. Thus, the GCA objects that long notification periods may harm ELV. Fortunately for German banks and their customers, the COR1 SDD has been created which allows German banks to use SDD and to take the critique of the GCA into account.*

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