"Vollgeld", virtual currencies and the idea of a cashless world

(mk) On June 10th, the Swiss voted on a proposal for sovereign money ("Vollgeld"). In a public referendum the proposal was soundly defeated (75.7% "no"- votes). If it had been accepted, it would have completely changed the country's banking system.

The proposed new system required bank deposits[1] to be covered 100% by central bank money. Hence the name "Vollgeld" for fully backed money.[2] Banks would be forced to separate "transaction accounts" (that would have to be fully backed) from other accounts, such as savings accounts. Deposits held in such transaction accounts would be as safe as central bank money. Under such a system, commercial banks would be unable to create money and credit. If a bank wanted to make a loan of 1,000 SFR it would first have to acquire 1,000 SFR in the form of central bank money (for instance by attracting deposits into its savings accounts). New money could only be created by the central bank. Unlike today, it would not be issued via central bank loans to commercial banks but it would be issued to the government or directly to citizens via lump sum transfers.[3]

In the course of switching over to such a system, banks' reserve requirements would rise significantly, making it necessary for the central bank either to provide banks with additional credit or to purchase some of their assets (possibly including customer loans) from them. In both cases, the size of the central bank's balance sheet would increase considerably. But even in the long run, central banks' balance sheets would probably be much larger than in "normal times". For instance, at the moment the volume of overnight deposits within the Eurozone is about EUR 6.7 trillion. Assuming that the demand for current deposits would not change, banks would need an equivalent amount in reserves.

Our Comment:

A lot has been written about the Vollgeld Initiative. Many comments have been rightly sceptical. The system would be either very rigid and prone to liquidity crises. Or it would be handled rather flexibly with the possibility of central bank credit for commercial banks. But in the latter case it would look a lot like traditional central banking.

Still, the Vollgeld initiative raises questions regarding the proper division of labour between central banks (government) and commercial banks (private enterprise). Interestingly, much the same questions arise when contemplating a cashless world and the future role of virtual currencies.

Given the diminishing role of cash in payments, the path towards a cashless society has often been portrayed as a minor step. However, doing away with cash would very probably lead to major changes in the existing two-stage banking system, cash being the only instrument that allows banks in this system to convert their liabilities vis-à-vis non-banks into central bank money.[4] If cash ceased to exist, private non-banks would no longer have access to central bank money, effectively rendering them “captive” in the commercial banking system. The special role of cash lies in the fact that it constitutes a broadly accepted means of redeeming banks’ liabilities vis-à-vis non-banks.

If doing away with cash were to make it impossible to convert deposits at commercial bank into central bank money, there would be mounting pressure to consider one of the options listed below:

- Deposits in central bank accounts available to everyone.
- Central bank digital tokens (e-euro).
- Some type of sovereign money.

In Sweden, where the use of cash as well as the quantity of cash held by non-banks have declined significantly in recent years, the central bank is already analysing the first two options.[5]

One option entails central bank accounts for everyone (“register-based e-krona”). Non-banks would be allowed to maintain deposits of their own at the central bank. It is therefore conceivable that giro accounts maintained by the central bank would compete with giro accounts maintained by commercial banks. However, in view of the secure nature of central bank deposits, there is also a strong case that this would lead to a marked shift in deposits to central bank accounts. Much would depend on the range of services offered by the central bank and on pricing. But in times of stress there would be a potentially huge flow of deposits from commercial banks to central banks.

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The **second option** entails digital tokens issued by central banks (“value-based e-krona”). Central banks would issue digital tokens (using blockchain like Bitcoin or other technologies) in place of physical cash. In this case the two-stage banking system could, in principle, continue to exist more or less unchanged. Instead of banknotes, non-banks would stock a certain volume of central bank digital tokens, though payment transactions would continue to be effected mainly via giro accounts held at the commercial banks, which would undertake to convert overnight deposits into central bank digital tokens “upon request”.

Nevertheless, this scenario may also give rise to much more far-reaching changes because central bank digital tokens is a much closer substitute for banks’ overnight deposits than banknotes. Whilst the specific features of any future central bank money are not yet known, it is safe to assume that it could be used to carry out remote payments. Consequently, payments currently effected using bank deposits could also be processed in part using central bank digital token. It follows that issuing central bank digital token would also entail the possibility that central bank money could replace commercial banks’ overnight deposits on a large scale.

As noted above, the Swiss have rejected Vollgeld in the recent referendum. But the closer some countries get towards a cashless society, the more appealing Vollgeld may become. Thus, for the future it has to be considered as a third option.

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If central banks become a force to be reckoned with in retail markets, some business models may be threatened.

Of course, the three options differ in many ways. But they will all have strong repercussions regarding competition between:

- banks and central banks
- banks and non-bank PSPs and
- central banks and non-bank PSPs.

If central banks become a force to be reckoned with in retail markets, some business models may be threatened. For instance, a chunk of the market for internet and mobile payments may be served by a bitcoin-like central bank e-money. Banks’ model of financing payment services via seigniorage (profits from non-interest bearing deposits) may be reduced because idle funds may be either placed in central bank accounts or kept with commercial banks only if an appropriate interest rate is paid.

On the other hand, there may be new business opportunities for banks and PSPs. Use of a bitcoin-like central bank money may necessitate new services such as custody (who wants to keep 50.000 EUR on a laptop?).

It is also possible that in payments the playing field will tilt towards PSPs. Banks having less seigniorage to pay for their payment services may have to raise charges, opening the way for more competition from PSPs. Vollgeld, in particular, would require banks to raise fees for transaction accounts. If payment and e-money accounts did not fall under the 100% reserve regulation, PSPs would have a competitive advantage.

Central Bank Digital Money (account-based or as digital tokens) and Vollgeld are unlikely to emerge in the next 5 years. Maybe they will never be implemented. The Swiss have soundly rejected Vollgeld and some central bankers have voiced severe concerns regarding CBDC.

“*A central bank might become a superpower in retail banking, disrupting traditional commercial banking by refinancing the credit supply via deposits. Commercial banks would have to increase interest rates accompanied by a fall in their margins in deposit and lending, endangering financial stability. In periods of stress, there is a high risk of digital bank runs.*”[6]

But it may not be up to central bankers to decide. The Swedish authorities did not decide “just like that” to explore the topic. They were driven by rapidly declining figures for cash use and cash stocks in the hands of the public in Sweden.

UK Payment Systems Regulator plans to undertake an acquiring review

(mk) As Sepp Herberger, the manager of the German football team that won the world cup in 1954 used to say: “After the match is before the match.” The same can be said of European payments regulation. Once a regulation or directive has been passed, market participants may already look forward to the next one. This is partly due to the review process, which often culminates in new or revised rules. One important review, the review of the Interchange Fee Regulation (IFR), is due in June 2019.

A taste of what may be in store is provided by a recent press release of the UK Payment Systems Regulator (PSR). In July 2018, the PSR announced that it planned to undertake a “*market review into the supply of card-acquiring services*”.[7] Apparently, various stakeholders have voiced concerns regarding the functioning of card acquiring in the UK. The PSR mentions the following points (p. 5):

- Interchange fee savings due to the Interchange Fee Regulation (IFR) have not been passed on to smaller merchants
- Lack of transparency with respect to fees
- Barriers to switching acquirers
- Barriers to offering switching services
- Scheme fees and scheme rules that favour large acquirers
- Rising scheme fees burdening merchants.

The PSR wants to explore whether these concerns are justified and if so whether they are due to a lack of competition. It is particularly concerned about merchant fees for small merchants and sees a possibility that harm to small merchants could be significant.

The outcome of the review could be inter alia “directions”, “guidelines”, recommendations for industry self-regulation, proposals to the Financial Conduct Authority (FCA) or a market investigation reference to the Competition and Markets Authority (CMA). Thus, depending on the outcome of the review, more regulation of the card payment sector may be on the cards.

Our Comment:

When regulators introduced a cap on interchange fees they did so with the expectation that lower interchange fees would lead to lower merchant fees and in this way ultimately to lower retail prices for consumers. Such an outcome rests on a number of conditions:

- no increases of scheme fees for acquirers
- no interchange fee rises for unregulated cards
- no large switch of issuers to unregulated cards
- acquiring is a competitive business
- retailing is a competitive business.

Moreover, as discussed in our last newsletter, there is an incentive for issuers to design debit cards that can be legally categorised as credit cards (and thus demand the higher interchange fee of 0.3%).

That 100% pass-through of interchange reductions is by no means straightforward.

The size of this list already makes it clear that 100% pass-through of interchange reductions is by no means straightforward. But to what extent this is due to "acquirer misbehaviour" is an open question.

As far as key accounts are concerned, interchange-plus contracts should make pass-through immediate and 100 per cent. For small and medium sized companies (SMEs) this may be a different matter. A recent study by two economists from the Bank of Italy shows that a 20 basis point (bp) reduction in interchange fees resulted in a 15bp reduction of merchant services charges (MSCs) in the first year and another 2bp drop in the second year.[8] Since these are the average figures, pass-through for smaller merchants may have been much smaller. So, all in all, pass-through of lower interchange fees has been substantial but not complete. It seems likely that these Italian results can also be applied to other markets. The interesting question is how regulators will view these results.

Pass-through is not the only issue that may interest regulators. In Germany and other places, retailers and acquirers are complaining about a proliferation of new scheme fees. Ulrich Binnebößel from the German Retailer Association (HDE) provides a non-exhaustive list of new scheme fees:[9]

- Authorisation Fee/Pre-Authorisation Fee
- Processing Integrity Fee
- (German) Innovation Fund
- Germany Card Promotion Fund
- Acceptance Development Fee
- Security & Quality Fund
- Dispute Administration Fee
- Card Not Present Unsecure Chargeback Fee
- Non-NFC Fee

It remains to be seen what the EU Commission will do about this "creative" invention of ever new fees. Apparently, the Commission did expect something in this direction. Therefore, the IFR contains a "Prohibition of circumvention" (Art. 5). It states:

"*For the purposes of the application of the caps referred to in Articles 3 and 4, any agreed remuneration, including net compensation, with an equivalent object or effect of the interchange fee, received by an issuer from the payment card scheme, acquirer or any other intermediary in relation to payment transactions or related activities shall be treated as part of the interchange fee*."

Thus, rising fees on the acquiring side could be seen as "circumvention" if they were used to reduce fees on the issuing side or pay incentives to card issuers.

As discussed by PaySys some time ago, this rule makes calculating interchange fees complex and invites further regulations.[10] For the moment, however, Art. 5 does not seem to be an effective brake on new fees on the acquiring side of the market.

The IFR does not cover all card types. One important segment that is not covered is the commercial cards segment. This provides an incentive to issue more commercial cards and to increase fees on commercial card transactions. The latter could be observed in France. The French scheme Cartes Bancaires (CB) raised the interchange for commercial cards from 0.3% to 0.9%.[11] This rate is still below the commercial card fees of Mastercard and Visa (around 1.25 to 1.3%). But for some sectors this increase has neutralised the (modest) effect of the interchange reduction on merchants' costs of card acceptance.[12]

Retailers and acquirers are complaining about a proliferation of new scheme fees.

One point that is also raised by the PSR is "fee transparency". The EU Commission has frequently criticised blended merchant fees and demanded more "transparency".

According to Art. 9 (1) IFR "*Each acquirer shall offer and charge its payee merchant service charges individually specified for different categories and different brands of payment cards with different interchange fee levels unless payees request the acquirer, in writing, to charge blended merchant service charges.*" In addition Art. 9 (2) specifies that "*Acquirers shall include in their agreements with payees individually specified information on the amount of the merchant service charges, interchange fees and scheme fees applicable with respect to each category and brand of payment cards, unless the payee subsequently makes a different request in writing*".

It is at least debatable that such an amount of information will make it easier for merchants to compare acquirer rates. For many merchants, in particular small merchants, one standard price, be it in EUR per transaction or in per cent of the transaction value, seems much more "transparent".

Notes

1 It is not clear how balances in e-money accounts or payment accounts would be treated. However, the logic of the proposal would require also a 100% reserve for such balances.
2 Such fully backed banking systems have been proposed on repeated occasions. See Bossone, B. (2001), Should banks be narrowed, IMF Working Paper 01/159, October.
3 In addition, the backers of Vollgeld also want to retain some flexibility by allowing central banks to buy or sell assets such as bonds in the open market. A brief introduction to Vollgeld in English can be found in: Sovereign Money Initiative. The Background to the National Referendum on Sovereign Money in Switzerland.
https://www.vollgeld-initiative.ch/fa/img/English/2017_05_02_Referendum_on_Sovereign_Money_in_Switzerland.pdf
4 This section draws heavily on Malte Krueger and Franz Seitz: Costs and Benefits of Cash and Cashless Payment Instruments in Germany. Module 2, The Benefits of Cash, expertise for the Deutsche Bundesbank, Frankfurt 2017 (also available in German).
5 See Sveriges Riksbank: The Riksbank's e-krona project. Report 1, September 2017. For a detailed study distinguishing 4 different scenarios see Olga Cerqueira Gouveia, Enestor Dos Santos, Santiago Fernández de Lis, Alejandro Neut and Javier Sebastián: Central Bank Digital Currencies: assessing implementation possibilities and impacts, BBVA Research Working Paper, March 2017.
6 Bundesbank board member Joachim Wuermeling in the Economist: Letter to the editor, June 7th 2018.
7 UK Payment Systems Regulator (PSR): Market review into the supply of card-acquiring services. Draft terms of reference, July 2018.
8 Guerino Ardizzi and Michele Savini Zangrandi (2018): The impact of the interchange fee regulation on merchants: evidence from Italy, Banca d'Italia Occasional Papers 434.
9 Ulrich Binnebößel: Payment-Entwicklungen aus HDE-Sicht, EHI-Kartenkongress, Bonn, 24. April 2018.
10 IF regulation: Is it the end or just a beginning? PaySys Report Issue 1, 16 February 2015.
11 Ninon Renaud: Les commerçants dénoncent la hausse du coût des cartes d'entreprise; 15 January 2018.
https://www.lesechos.fr/15/01/2018/lesechos.fr/0301152476527_les-commercants-denoncent-la-hausse-du-cout-des-cartes-d-entreprise.htm
12 The average CB interchange rate fell from 0.29% to 0.26%.

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