In this issue:

1. IF-Regulation & American Express: In or Out?
2. Trial against Cash
3. Varoufakis´ plan for a new payment scheme

IF-Regulation & American Express: In or Out?

The 9th December 2015 is very near. According to the Interchange Fee Regulation (IFR 2015/751), Member States should have designated local competent authorities to ensure the enforcement of this regulation by now. The Member States should have made decisions about the optional rules to introduce lower caps for credit and debit card transactions as agreed in the Regulation (0.3 and 0.2% respectively). Alternatively, they should have decided to allow an IF above the equivalent of 0.2% for specific domestic debit card transactions for an interim period of 5 years - if the weighted IF-level for all domestic debit card transactions stays at the maximum of 0.2%. For the time being, it seems that most of the Member States have decided not to practice this interim exception for domestic schemes. It seems to be a wise decision, because merchants would practice interchange-arbitrage by swiping the transactions priced with an IF-tag above 0.2% to acquirers outside the country.

Local authorities may also exempt non-genuine three-party card schemes for a maximum of 3 years (until 9 December 2018) from the IF-caps for domestic transactions if the transactions made in the specific country are below 3% of all card-based transactions made in that Member State. Non-genuine three-party schemes are card schemes with licensees on the issuer or acquiring side or schemes issuing card-based instruments with a co-branding partner or through an agent. American Express obviously fulfills the conditions for such a scheme by issuing their cards not purely within a three-party-model, but also with issuing partner banks (Global Network Services – GNS) and within a co-branding relationship. The leading British competent authority on IFR - the PSR (Payment Systems Regulator) - will probably exempt the American Express scheme on the basis of the 3% criterion. In other Member States, where local entities are issuing Amex cards, local regulators intend to take the same decision, at least for a 1-year-exemption. However, in Latvia the local regulator decided not to exempt the Amex-cards issued by the Citadele Banka.

Our Comment:

The enforcement of Chapter II (caps) of the IFR regarding American Express seems to be a tricky issue. Market researchers estimate that about 15% of the Amex cards in the EU are issued in a GNS-relation with financial institutions (4-party from a regulatory perspective) and 85% as closed-loop (3-party). Independently of these issuer-structures we see a considerable number of co-branded portfolios (e.g. British Airways in the UK, Payback in Germany). However, all Amex cards are obviously subject to the same single set of rules, practices, standards and/or implementation guidelines for the execution of payment transactions with this brand. From a regulatory point of view American Express is a single “payment card scheme” (according to the definition of the IFR Art. 2 (16)).

The first point at issue is the proper interpretation of Art. 1 (5), repeated as a definition in Art. 2(18):

“When a three party payment card scheme licenses other payment service providers for the issuance of card-based payment instruments or the acquiring of card-based payment transactions, or both, or issues card-based payment instruments with a co-branding partner or through an agent, it is considered to be a four party payment card scheme.”

The result of a simple reading is the consideration of the Amex scheme in total as being a four party scheme. A more sophisticated reader sympathetic to Amex could argue, that “when” should be read as “in the situation where”. Therefore only in these cases (licensees, co-branding, agent) is the scheme partly (not in total) considered as a four party scheme. The result would be a regulatory scheme-splitting into two sub-schemes: Amex-portfolios issued in a genuine three party model and portfolios issued in a licensee, partner and co-branding relationship. The three party Amex cards are exempted anyway, the four party cards are subject to the caps or could be exempted temporarily by the 3% criterion.

Such a portfolio-related interpretation of this article of the IFR seems to be favored by some local authorities, as in Latvia, but is it the intention of the legislator? It is remarkable to see the same demarcation line between a 3-party and a 4-party-scheme in the PSD II in the context of the obligatory opening of payment systems for PSPs. Recital 52 says that the provisions related to access to payment systems should not apply to strictly closed loop 3-party schemes *“to the extent that they never operate as de facto four-party schemes, for example by relying upon licensees, agents and co-brand partners.”* Conversely, if the three party card scheme is not 100% closed loop, the whole scheme would be subject to the access provisions.

Within the PSD II-context the legislator is obviously following a scheme-related interpretation: the scheme as a whole is either subject to the provisions or not. This interpretation would also be in line with the overall rationale behind the framework of the IFR, which is always: “card scheme/brand” in combination with “card category” (debit, credit, commercial and prepaid cards) as parameter for provisions (IF-caps, Honour All Cards rule, unblending, optical and electronic identification of the cards at the terminal etc.). There is no third dimension for specific card portfolios (e.g. co-branding cards) or specific issuers (e.g. licensees). It will be confusing for merchants and consumers, if a merchant intends to accept only cards of a certain category (e.g. debit cards) which are subject to the IF-caps, from which some issuer-related portfolios are exempted

All card transactions with Amex in Germany, Poland, Italy, Spain, Demark, Austria and Netherlands are per definition cross-border transactions, which are not exempted from the IF-caps.

Which remuneration has an equivalent object or effect of the interchange fee within a semi three party scheme?

In this case, the merchant has to communicate something like: *"Dear customer, I accept Amex Cards, but only the co-branded cards and the cards issued by Bank A, B and C."* Or: *"I accept all Amex cards, but you have to pay a surcharge for the cards, which are not co-branded or not issued by Bank A, B and C."* Pretty unrealistic!

The local regulator has to deal with another question. Are all Amex cards, excluding the cards issued in a four party structure according to the definition (licensees, co-brandings, agents), issued and acquired by the scheme itself? In Europe we see several local entities, joint ventures of Amex with banks or fully owned by Amex, which are the legal issuers of Amex cards (e.g. American Express Carte France, Alpha Card in Belgium and Luxemburg). Are these entities "other payment providers", which are other than the scheme itself? If the answer is yes, all cards issued by these entities are subject to the four party scheme.

On 17th November 2015 the UK Government approved HM Treasury's stance on interchange in Parliament, which will come into force from 9th December.[1] The UK Parliament decided:

"Until 9th December 2018, a payment card scheme and persons acting under that scheme are exempted from the obligations, prohibitions and restrictions under Chapter II of the interchange fee regulation (maximum interchange fees) in relation to domestic payment transactions if the scheme is a three party payment card scheme which is to be considered to be a four party payment card scheme pursuant to paragraph 5 of Article 1 of the interchange fee regulation and the scheme meets the condition in the final sentence of that paragraph."

The question remains whether the whole scheme as such (including the strictly closed loop issued cards) are considered here as a four party scheme or only the specific card portfolios, which are issued in a four party-structure? Is the whole Amex scheme (including the cards issued in a strictly closed loop) exempted until December 2018 (if the market share is below 3% of the UK card market)?

The scheme-based approach would have huge consequences. The UK-based American Express Services Europe Ltd. is probably the main issuer of Amex cards in Europe. Amex cards in Member States like Germany, Poland, Italy, Spain, Demark, Austria and Netherlands are cross-border issued from the UK. If the British regulator PSR is exempting the whole Amex scheme according to Art. 1 (5) of the IFR, the exemption is only relevant for domestic transactions (issuer, acquirer and merchant are located in the same country). All card transactions with Amex in the Member States mentioned previously are per definition cross-border transactions, which are not exempted from the IF-caps.

Merchants will welcome this cost reduction, but until then another problem has to be solved by the PSR (and other local regulators). How to determine the references for the 0.3% cap if there is no dedicated interchange fee in the Amex scheme? The IFR remains silent on this question by delegating this tricky issue to the local regulators. The PSR would have to make clear specifications to indicate the references for the 0.3% cap in the case of issuing Amex cards in a strictly closed loop, licensee, co-branding and agent environment until 9th December 2015.

Which remuneration has an equivalent object or effect of the interchange fee within a semi three party scheme? Is it the provision paid to the licensee, agent or co-branding partner? If yes, the consequence would be a portfolio-related “interchange fee”.

Even if the PSR supports the portfolio approach (instead of the whole scheme approach), by exempting the Amex cards issued in a four party environment only, the issue has to be solved within the next two weeks for all the non-domestic transactions, which are subject to the IF-cap, made by these cards. As an example: all merchants in Europe outside the UK should benefit from the capped “interchange fee” for POS-transactions made by the German holders of Amex cards co-branded with Payback (issued in the UK) from 9th December 2015 onwards as a consequence of the expected exemption from the PSR.

Let´s wait and see how the Brits interpret the IFR and what will happen in the next weeks.

Anyway, American Express will probably take the grace period of Article 1 (5) to re-build its card scheme in the four party area to meet the regulatory challenge. An option would be to set up a new scheme brand to separate third party from four party, e.g. Amex blue and Amex green. In the meantime, the lower merchant service fees for MasterCard and Visa – as a result of the IFR - will put pricing pressure on the acceptance of the Amex card. Amex will probably not have a strong enough value proposition to sustain its premium price model. Regulators (European Commission included) should use this grace time to develop a sound methodology for referencing “interchange fee” in schemes without explicit interchange fees.

Lower merchant service fees for MasterCard and Visa – as a result of the IFR - will put pricing pressure on the acceptance of the Amex card.

Trial against cash ends with a clear verdict: „not guilty“

On November 3rd, the University of Zurich, the European Money and Finance Forum (SUERF) and Liberales Institut organised a conference with the title “cash on trial”. The “trial” took place under the strict guidance of judge Llewellyn (Loughborough University) and involved a prosecution, a defense, a number of experts and a jury.

Following an overview of the issues by Malte Krueger (Hochschule Aschaffenburg and PaySys Consultancy), and an analysis of the long-term trend of cash in circulation by Helmut Stix (Oesterreichische Nationalbank), the accusation was read out by the judge. It contained three elements:

1. Cash facilitates crime.
2. Cash is an inefficient means of payment.
3. Cash prevents monetary policy from setting negative interest rates.

Subsequently, the battle between defence and prosecution unfolded. Below, we will summarise some of the contributions that are related to payments.[2]

The prosecution presented the arguments of Kenneth Rogoff (a former IMF chief economist), who proposed to abolish cash in order to fight tax evasion and black market activities. Moreover, they stressed macroeconomic aspects put forward by Rogoff, Willem Buiter (Global Chief Economist, Citi) and others. The first expert called upon by the prosecution was Harry Leinonen (Finnish Ministry of Finance) whose plea against cash was focussing on payment related issues. Leinonen argued that it was wrong to prosecute cash. Instead, regulators, politicians and consumer organisations should be prosecuted because they were the ones responsible for keeping cash artificially alive. In his view, these players are responsible for tilting the playing field in favor of cash. The fact that regulators allow interchange fees (albeit at low level) implies that card payments are relatively expensive and that card issuers earn uncompetitively high fees on card payments. If card holders are using cards to withdraw cash, card issuers have to pay fees whereas cash users usually don’t pay anything (often due to regulation).

Thus, according to Leinonen, card payments are subsidising cash withdrawals. Cash is also subsidised by central banks. Leinonen points out that large value notes are big money spinners for central banks (at least in times of positive interest rates). But small notes would actually cost a lot to process and fees and seigniorage would not be sufficient to cover the costs of small notes. Overall, Leinonen made a strong case for transparent pricing. He argued in favour of abolishing interchange fees and called the well-known “Merchant Indifference Test”, used by regulators to determine the size of these fees, a “Major Indifference Trap”. “How can a more biased price imply efficiency?” he asked. In a similar vein, he strongly came out in favor of allowing surcharging. Finally, he proposed to abolish the special role of cash as legal tender. Rather shops should be required to accept cards.

The defence questioned these arguments and a presented a number of experts that presented arguments in favor of cash. Some of these arguments were focussing more on macroeconomic aspects. Nicole Jonker (De Nederlandsche Bank), however, also stressed some aspects related to payments.

First, she pointed out that cash still has a very strong position in the Dutch retail payment market. 57% of all transactions are in cash. In order to explain why this is the case, she drew on results of a Dutch consumer survey. As she pointed out, in 2004, the top-3 reasons to use cash were

1. Cash is faster,
2. Cash helps monitoring expenses,
3. Only cash is accepted.

In 2014, the results looked quite different:

1. Cash helps monitoring expenses,
2. Use cash because it is a habit,
3. Use cash to cut expenses.

Supplementing these results with findings of other research, she pointed out that, on average, cash payments at the POS are still faster than are payments. Moreover, card acceptance is still far from 100% in some sectors. Thus, there are some obvious reasons for preferring cash. But as the recent survey result show, budgeting has become more important. At least for a significant fraction of the population cash is an important means for controlling expenditure.

After the appearance of the witnesses of the defense, the court heard a number of experts. Friedrich Schneider (University of Linz) focussed on the use of cash in criminal activities. Schneider strongly emphasized how little we know and strongly expressed his doubts with respect to some of the figures that have been widely quoted. Looking at transnational crime, he finds that for OECD countries above 2% of GDP are not plausible. Of these 2% two thirds are financial crimes and tax fraud – both almost exclusively non-cash. He also looked at figures for national criminal money flows. For countries like Germany or Austria he estimates a size of about 0.5% of GDP. Within this category of crime, cashless crimes such as cyber crimes are becoming ever more important. As Schneider points out, if you hire black labour you can also pay by card. You simply take your "service supplier" to the next super market or electronics store and pay the bill for him/her by card. In some sectors, prepaid phone cards are also a widely used substitute for cash. Overall, Schneider argues that the crime reducing effect of abolishing cash should not be overestimated: *"A reduction of cash can reduce crime activities as transaction costs rise, but as the profits of crime activities are still very high, the reduction will be modest (10-20% at most!)."* Thus, other measures might be much more effective in reducing crime, for instance a liberalization of drug trading.

Nikos Passas (Northeastern University, Boston) pointed out that the largest scandals and disasters of the recent past were "no cash incidents". Even 9/11 involved only one cash transaction ("and that was with identification"). Moreover, given the huge number of people without an account, how could we contemplate going cashless? For Passas this looks like misguided regulation and he used the example of Hawala to show how such regulation can do more harm than good. "Fighting terror with error", as Passas puts it.

The jury duly considered all of the aspects of the arguments presented by the prosecution, the defense and the experts and came up with a clear verdict: on all counts "not guilty".

When we try to explain why the usage of payment instruments differs across countries, there always remains a large unexplained part which we then call "payment culture".

So, the verdict is clear. It comes as the result of an exchange of arguments "pro cash" or "contra cash." Participants were either experienced practitioners or academics. Thus, one should expect a rational process of weighting the arguments. But when looking back, at the presentations as well as at the discussions during coffee breaks, an old insight comes to mind. When we try to explain why the usage of payment instruments differs across countries, there always remains a large unexplained part which we then call "payment culture".[3] "Culture" definitely was also important at the Zurich conference. When deciding why somebody was pro-cash or against cash, the single most important variable was the general attitude towards the state. If one sees the state as augmenting the welfare of the people, the loss of control that comes with the use of cash is seen as clearly negative. If one sees the state as a potential threat to liberty, cash looks like a perfect instrument to keep some liberty (and privacy). Interestingly, the Swiss, living in the homeland of one of the worldwide show-cases of democracy, seem to have a fairly sceptical view of government and thus a positive view of cash. The Austrians and Germans seem to agree. But in Scandinavia the dominant view appears to be quite different. Thus, it would be interesting to repeat this trial in Scandinavia. What would the verdict be?

Varoufakis´ plan for a new payment scheme

At the end of July 2015 the Greek newspaper "Kathimerini" revealed the activities of a secret working group initiated by the former Greek Finance Minister Yanis Varoufakis. The working group had prepared contingency plans for the threatened Grexit or for a longer 'bank holiday' in case the Greek banks were shut down as a consequence of the debt crisis. The group was coordinated by Prof. James K. Galbraith, American economist and old colleague of Varoufakis. Worldwide attention was given to the plan for a parallel payment system based on tax account numbers. Varoufakis was accused of hacking the tax numbers of all Greek taxpayers. Legal action was planned against the superstar, even accusing him of high treason. The police conducted an investigation but found no evidence of the hacking activities. The case was forwarded to the Greek parliament, which is responsible for conducting an investigation if political figures are involved.

Our Comment:

Just before the publication of the alleged sensational hacking by the former Minister of Finance we discussed the idea of a parallel currency (beside the Euro) in our Report (No. 4-5) as Plan B (alternatives to the status quo or Grexit). Because of the existing statutes of the Greek Central Bank the issuance of a paper-based complimentary currency, like an IOU[4], is – without amending the statutes – not possible. Furthermore the ECB will probably not tolerate IOUs, denominated in Euros, whose acceptance is mandated by law like legal tender, as Mario Draghi wrote recently in his answer to a question by the Greek EU-Parliament Member Eva Kaili.[5]

As a way out, we suggested the idea of a cashless complementary currency in a strictly closed loop, issued by a private entity or even by the government itself. Possibly Varoufakis had the same idea. His Plan B of a parallel account-based payment system is still vague. In his official statement of July 27th Varoufakis outlined his scheme as follows[6]:

- Extension of the Taxisnet (the Greek portal of the Ministry of Finance for online tax declarations with a personal account of the taxpayer) to a payment scheme,
- A payment scheme for cashless transfers between the state and taxpayers as well as between taxpayers,
- The scheme should be implemented independently of the negotiations with Greece´s creditors.

Further details were not published. The tax number should probably be used as the account number, just as PayPal is based on the email address as account identification. Residents who already have a tax number are usually identified. It solves the KYC-issue of this additional current account, held at a "bank", fully owned and controlled by the state. The more interesting question is the initial creation of the funds as "fiat money". The government could start transferring its social benefits and pensions to these new accounts. A second way of creating new liquidity is by granting loans to taxpayers.

The tax history of each account holder could deliver information about the creditworthiness of the borrower. Further, the government could create new jobs through infrastructure relief projects or other public investments, funded by the newly created liquidity. Only residents and companies who are willing to accept the complementary currency would be included as beneficiaries of these public investments. The acceptance of the funds by citizens would be facilitated through the acceptance of the government itself as a player in the scheme, e.g. for tax payments. The payment scheme could be set up as a strictly cashless closed loop without redeemability and convertibility to Euro by using a unit of account which is equivalent to the Euro.

Regrettably, we currently have no more facts about the Plan B of Varoufakis and his Working Group, which was not a contingency plan for re-issuing the New Drachma in case of a Grexit. In his earlier writings, Varoufakis rejected privately issued currencies like Bitcoin. From his perspective *"there can be no de-politicised currency capable of 'powering' an advanced, industrial society"*[7]. The currency should be controlled by a democratic, collective agency, which cannot be an independent central bank. The government would reclaim its monetary sovereignty by disempowering the central bank and the banks´ power to create scriptural money.

The ECB and banks won´t be enthusiastic supporters of such revolutionary ideas.

These monetary reform proposals are not new but have been increasingly discussed lately around the world ("sovereign money", "100%-money", "positive money", "Chicago-Plan").

In September 2015 a group of left-wing politicians from Germany, Italy and France (such as Lafontaine, Mélechon, Fassina) joined Varoufakis in a public appeal for a democratization of the Euro, which could be achieved through an evolutionary process by creating *"parallel payment systems, parallel currencies, digitization of euro transactions, community based exchange systems, the euro exit and transformation of the euro into a common currency."* [8] The ECB and banks won´t be enthusiastic supporters of such revolutionary ideas. However, it looks as though in Greece such ideas were about to be realized this summer. The debate is not over yet.

Notes
1 http://www.legislation.gov.uk/uksi/2015/1911/contents/made
2 Contributions of a more macroeconomic type are not considered here. Just as those presentations summarised in this article, the interested reader will find them under www.suerf.org/zurich2015
3 See, for instance, Knud Boehle and Malte Krueger, Payments Culture Matters – A Comparative EU-US Perspective on Payment Cultures –, Background Paper No. 4, Electronic Payment Systems Observatory, Institute for Prospective Technological Studies, Sevilla 2001. (http://ftp.jrc.es/EURdoc/eur19936en.pdf).
4 IOU (I Owe You): Informal document acknowledging a debt owed
5 https://www.ecb.europa.eu/pub/pdf/other/151022letter_kaili.en.pdf?8edfe339021c089c045d9e06ab671277
6 http://yanisvaroufakis.eu/2015/07/27/statement-by-yanis-varoufakis-on-the-finmins-plan-b-working-group-the-parallel-payment-system/
7 http://yanisvaroufakis.eu/?s=apolitical+money&submit=Search
8 http://www.jean-luc-melenchon.fr/2015/09/11/a-plan-b-in-europe/

Should you have any questions or comments please contact:

Dr. Hugo Godschalk (hgodschalk@paysys.de)
Dr. Malte Krueger (mkrueger@paysys.de)

Please, send us your views to:
paysys-report@paysys.de

PAYSYS REPORT IMPRINT

PaySys Consultancy GmbH
Im Uhrig 7
60433 Frankfurt /Germany
Tel.: +49 (0) 69 / 95 11 77 0
Fax.: +49 (0) 69 / 52 10 90
email: info@paysys.de
www.paysys.de

PAYSYS REPORT
November 2015

Layout: cristina dresler | kommunikation+gestaltung

Subscription info:
The PAYSYS REPORT is published 10 times a year in English in electronic format (pdf) and contains about 4-6 pages.
The price is
250 EUR per year (single user license)
500 EUR per year (company license)

To order, please send an email to paysysreport@paysys.de indicating the type of license you wish to purchase and the method of payments (credit transfer or credit card).

PaySys Consultancy is German member of

epca european payments consulting association

PaySys Consultancy GmbH