

The E-Money Directive's benefits & areas for improvement

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When Thaeer Sabri from the EMA asked me whether I would be willing to join this conference I asked him what you want me to say. His answer was both a relief but also somewhat frightening. He said: Say something inspirational! That meant to me my speech would not have to be particularly informative or technical. So I would not have to get up to speed with depth and details of the debate on the Revision of the E-Money Directive and the wider context of the new legal framework for payments. And that was the good news. At the same time I felt the prospect of having 15 minutes to be inspirational terrifying. So probably the bottom line of the remaining 14 minutes will be: Little information for not much inspiration. It'll be for you to judge. In order for that judgement not to be too harsh I thought I should make an effort to be at least entertaining. You will see.

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We have come a long way! Here you see on the right Kauri shell money used 2000 years before Christ. On the left you have boat money from Thailand, used about 1000 years before Christ. When I was looking in the Google picture area for photos of ancient forms of money I thought it'll be probably difficult to find any. I was completely wrong. The place is full of pictures with a wide range of ancient forms of money. Why is that? Simple! In not that surprising twist of Karl Marx' commodity theory of money – Marx thought as for any other commodity the value of money is driven by the cost of producing it, in other terms by the cost of mining gold – in a twist of that theory, money, at least some forms of money, have become a commodity. However their value is not driven by the cost of production but rather by offer and demand on a still rapidly growing marketplace. Guess which market place I am referring to? Yes – it's eBay.

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You can buy money on eBay and it's not particularly expensive: one day before the ending of that offer the price stood at €5.50 cent with a charge for shipping of €4.50.

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What this means of course is that very old forms of money sit next to the most advanced forms of money in close and good neighbourhood. Pay Pal is there offering a most convenient way of paying for your Thai money and you're not charged €4.50 for the shipping. Is there anything to complain about?

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Pay Pal is offering a little more than just electronic payment. You have the Pay Pal Käuferschutz for free or in English

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The buyer protection - what is this about?

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Pay Pal offers a guarantee. It covers damage of up to 500 pounds for items you have paid for but never received or items that are significantly not as described a very good thing for customers to have. In the UK it doesn't pose any problems.

In Germany it does. As the saying goes „you always find a fool to make a rule“. And now what's the problem with the German Käuferschutz.

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The simple and somewhat cryptic answer is: It's Nr. 8 on the assumption of guarantees - in other even more cryptic terms it's the problem of the proverbial elephant - difficult to define but you know it when you see it.

Now we are approaching probably the most fundamental and far-reaching benefit the E-Money Directive brought about which at the same time is one of it's most embarrassing deficiencies. It's the definition of e-money and e-money institutions.

But back to the elephant and Nr. 8. Everyone sort of knows what a bank is but in Europe you find quite a range of ways how to define it.

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This is Nr. 8 of the German definition of the notion „credit institution“. It refers to “the assumption of guarantees and other warranties on behalf of others” – in short: guarantee business. If you are in the guarantee business in Germany you are a bank, in the UK you are not. And it took us quite some time to come to the conclusion that what Pay Pal is doing in Germany on the back of its UK licence is for the UK, for the FSA, to police. It is covered by its European passport issued by the FSA and, therefore, does not require a separate German banking licence for conducting guarantee business.

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And of course Nr. 8 is just Nr. 8 and there are 10 more types of business activities that in Germany make you a credit institution subject to a licensing requirement.

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Now if you compare the German definition of credit institution to the definition you find in the European banking directive - the little bit of language that is coming up here - not 4 legs like an elephant, not 11 legs like the definition in section 1 of the German banking act, just two legs to stand on – if you compare these definitions, you will probably assume that German regulators like elephants. I certainly do. Still, as a matter of principle, I would try hard to keep elephants out of banking regulation. So far that has been rather unsuccessful and I have to admit that section 1 of the German banking act has another 24 paragraphs to offer – and I take little consolation from the fact that not all of them are quite the size as paragraph 1.

But where is the benefit from the E-Money Directive? To put it in a very personal way: without the Directive those of you that are in the business of issuing e-money would be either bankers or would do something entirely else. As a matter of fact the second leg of the EU definition of credit institution means that issuing

e-money does not amount to being in the first leg - to taking deposits. It therefore does not require complying with the heavy load of European and national regulation deposit takers - traditional banks and bankers - are subject to.

You may think - from your personal perspective - that it would be much better for you to be a banker or to do something entirely else. From a market perspective I would still believe that it was a very sensible decision to open up that particular business of issuing e-money to other players than traditional banks. In other terms the E-money directive should not simply be judged as some ugly regulatory duckling but in the first place it should be judged by its merits as a very necessary and sensible piece of deregulation.

Whatever the end result of the revision of the E-money directive is - thanks to the initial deregulatory direction that has been taken, that e-money institutions will never have to implement Basel II. Which, I can assure you - since I have to implement that monster - could be conceived as a pretty good reason for getting into the business of issuing e-money or do something entirely else than supervising banks and bankers.

But let's have a closer look at that duckling now - why it is what it is - and where it calls for improvement. And now the time has come for confessions. When the idea came up that a European regulatory framework was needed for the issuance of e-money I happened to work at the European Commission. I was seconded by the German supervisory authority to the Banking Department in DG 15 and whilst having a lot of fun with negotiating the Capital Adequacy Directive 2 at the Council I was asked to have a go at the drafting of a directive on e-money. The mission was very clear: Deregulate so that the entry barrier for the e-money industry which at that time was at best fledgling - comes down and competition would extend well beyond the traditional breed of credit institutions - meaning the deposit-takers of the first leg of today's definition of credit institution. The initial and most challenging hurdle to overcome was to convince myself, the banking department, the Commission's legal service, European banking supervisors the ECB and quite a few others that e-money is not a duckling or a duck but a rabbit.

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That of course refers to Wittgenstein's famous duck-rabbit which you see here. Does anyone see a rabbit? Now put duck for deposit and rabbit for e-money and you can see what I mean. Overcoming that first hurdle turned out very quickly to be a tall order. Why? Well - as for Wittgenstein's rabbit and depending entirely upon your perspective, the way you have learned to look at such rabbits, they look terribly like ducks. In other terms there are many forms a deposit may take without anyone seriously doubting that they are what they are: deposits. As with my earlier elephants there is not much of a definition of deposits. According to Art. 4 of the banking directive it's just some sort of repayable fund taken from the public. Hardly a definition of deposit - but you still know it when you see it. And looking at e-money, initially, everyone saw a duck - a deposit.

For very good reasons. Issuing e-money meant and still means taking money from the public and repaying it either in the form of transfer as electronic payment to some merchant that accepted that e-money or by paying it back in cash to the initial e-money holder.

And here comes a rather fundamental thing about regulating - and - as the case may be - deregulating financial markets. It's not simply that you respond to an economic reality, in fact you create that reality. In order to make people see the rabbit we, at least to some extent, had to invent that rabbit, describe and eventually define e-money. The problem is: When you try to define elephants you run the very real risk of getting it wrong. Especially when reality is just offering you a fledgling duckling without any chance to see the swan it may turn out to be.

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For inventing, creating that new rabbit reality there was a helpful formula to work with. As everyone knows EU regulation of financial markets is governed by an equation that - at least at first glance - appears to be plain evident and very convincing.

"Same risks = same rules."

It was clear that we didn't want the same rules as for deposit takers. We wanted

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other rules, a lighter regime. We wanted to deregulate in order to help – one could put this way - the rabbit to fly.

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Given that equation it was obvious that we would get to other rules only if there were other risks. And there was a problem here. The product as such had some generic features. It was clear for instance that the electronic nature of e-money implied in particular quite a range of operational - IT related risks. At the same time there was nothing in the nature of that product to keep customers from holding considerable amounts of funds for an extended period of time as e-money - funds that otherwise would have deposited in a bank. Our argument had to become somewhat circular. In order to get to other lower risks we had to put in other, more restrictive and risk-adverse, rules.

It should be clear by now that I am not just speaking of the definition of e-money in Art. 1 (3) (a) of the E-money directive but of the directive as such – the regulatory regime we designed around e-money to make it a very low risk product. Close to legal tender, as safe as real money, money for which no-one seriously envisages the issuer to go bust.

So, in order for the duck to be seen as a rabbit we did not regulate a given product – e-money. Instead what we did and had to do – we had to invent the basic features of a business model that did not exist and had not been tested beforehand. In particular we had to make sure that this electronic money is fully and at all times backed by high quality assets. Therefore, we had to put strict limits to the risks, to market, credit and concentration risks associated with the investment of the float. Only once that - in some respects much harsher regime than the regime for banks - had been sketched out the Commission's legal service and quite a few other players involved saw the rabbit; a rabbit that had never really been exposed to the wildlife of real economy.

Responding to the question how to improve the E-money directive my main message is: Understand that this directive is not in the first place a piece of regulation or rather deregulation that responded to e-money as a given product. The starting point for a revision of the E-money directive should be to look at it as a directive that more than anything else invented a new business model – a

business model for a low-risk deposit-taker offering electronically accessible deposits that would be sufficiently safe to be viewed and used as money.

It's still a duck – somehow.

And 5 years after the coming into force of the directive – five years into reality – albeit a small size reality of the e-money market, regulation should now analyse and respond to the business model and the risk profile of e-money institutions as they have evolved.

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An important aside - same risks – same rules still is and has to remain the regulatory dogma. So don't tell me that there is something like a hybrid issuer. I am prepared to accept that one can be a little pregnant and hence qualify for a waiver subject to conditions that are commensurate with the actual risks. But whatever the range of your business activities - if compared to other e-money only businesses you are very pregnant - and some mobile phone operators seem to be very pregnant - you have to come under the same regime; whatever that regime may be.

Some final remarks on the benefits of the E-money directive and regulation more generally, remarks that may also help for improving the directive.

Earlier on I mentioned Basel II. For a good part of the 7 years of negotiating Basel II I have been involved in this mega project and still am in as far as national implementation is concerned. Living through this, one thing becomes very clear. Regulation is not the four and a half pages e-money directive or the phone book size CRD published in the Official journal. Regulation is a process. And regulation of financial markets a rather complex process. A process that aims at innovation, not just regulatory innovation also innovation in financial markets.

That is inconceivable without communication – communication with other regulators, but just as much and perhaps even more so - communication with the industry. And here it is time for my second confession. Not only that I was heavily involved in the drafting of the e-money directive, I also implemented that directive in the UK when working for the FSA in 2001 and 2002. For that

implementation we took the time to discuss issues at length with the emerging e-money industry in the UK. An exercise which from my perspective as a regulator was extremely beneficial and, I dare to contend, beneficial also for the UK e-money industry. It helped enormously the understanding of issues, risks, and potential on the side of regulators and on the side of the industry.

Back to Basel II. The Basel II process not only triggered far-reaching and healthy innovation in financial markets, it also triggered an increasingly rich debate in sociology. Since the late nineties sociology is exploring regulatory processes, styles and concepts. As one among many other voices I would just like to present to you some thoughts of the Niklas Luhman school in German Bielefeld.

Here you have some quotes from a recent article of Torsten Strulik and Matthias Kussin in "Financial Market Regulation and Knowledge Politics":

"... It is apparent that the **strategic creation of innovation** is a crucial aim in economics, politics and law. ... Of central interest is if and to what extent the **new 'cognitive' supervisory regime (Basel II)** creates conditions for a **mixed public-private form of risk management** that is in accordance with the increasing demands for the **creation of stability and innovation.**"

„ ... For the regulation of the banking system this means, that **within the frame of public-private arrangements collective learning** may be observed ..."

"Basel II - **the regulatory constitution of collective intelligence**"

Collective learning – collective public-private intelligence is crucial and extremely beneficial for regulators, regulation and regulated firms. From that perspective regulation of e-money in the UK, the implementation of the E-Money Directive was hugely beneficial and may well have helped this market to become probably today's most mature e-money market in Europe.

A final word for those working on the revision of the E-money Directive: Beware of the elephants.

Thank you!