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MODULO JEAN MONNET

BUILDING UP A EU-BASED PAYMENT SYSTEM. LEARNING FROM THE PAST TO ADDRESS THE CHALLENGES AHEAD

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CALL FOR PAPERS

Building up an EU-based payment system. Learning from the past to address the challenges ahead

Autumn School, 23-25 October 2014

Within the framework of the *Jean Monnet Teaching Module* on the "*Europeanisation* of the payment system", the Department of Business and Law of the University of Siena has the pleasure of inviting international academics and professionals working in the field of payment systems to submit proposals for papers. The participation of Ph.D. and tenure track scholars is particularly welcome.

We welcome proposals from scholars working in the fields of law, political economics, economics, sociology, management, cultural studies, anthropology or any other discipline seeking to engage seriously with the questions posed:

- Building up the EU-based payment system is a long-standing process. What can the historical development of the European integration process and, above all, banking history teach us?
- The process of integrating European payment services has made many steps forward. There are Community rules for service providers, framework contracts, contract remedies and a duty of information, in addition to regulatory and technical standards for direct debit, card payments and credit transfers. How are Community-based rules changing domestic jurisdictions?
- In an EU-based payment system, financial and banking intermediaries perform a critical role. What about the new service providers (for example m-payment services)?
- Money is also a means of membership and the EU law on money may contribute to create a sense of Community identity. What kind of "money" could improve the relationship between the European Community and the individual citizen?
- The European Union claims to be a pluralistic community. How should "cultural pluralism" be accommodated in the EU-based payment system?
- In the process of building up a Community-based payment system, there is a trade-off between competition and stability. What kind of balance can be reached?
- The EU-based payment system framework covers all Member States. How does the dualism between Euro and non-Euro Countries challenge the *Europeanisation* of the payment system?
- What should we expect from monetary policy and European Central Bank?
- How does the EU-payment system match up with the political vision of Europe?

The event is a three-day workshop to be held at the University of Siena from 23rd to 25th October, 2014. The workshop will be held in English and no translation services will be provided.

INTEGRATION OF THE EU PAYMENT SYSTEMS: A "TOLERABLE STRAIGHT LINE"?

Daniele Ciani and Paola Masi[1]
Bank of Italy

The way to the EU single internal market, a pillar of the Treaty of Rome (1957), was paved only in the 1980s with the Commission's White book on "completing the Internal Market". This gave rise to an intense legislative activity, continuing until 1992, and a complete framework legislation for the creation of an extensive market, implying the development of economies of scale, competition and growth. Little or no attention was paid to matters of financial stability. After the introduction of the single currency (1999) and following on developments in the financial sector, considerable advance has been made in the integration of payment and settlement systems, for both wholesale and retail transactions. However the process still needs to be completed and the consequences of the recent economic crises seem to have damped down the momentum of and consensus on linear progress towards the economic integration in Europe. The impact of financial stability on the integration process can no longer be disregarded, and the costs of integration cannot be ignored. This paper has the objective of highlighting the economic and regulatory drivers of integration in payment systems after more than two decades of experience. Its main purpose is to contribute to a non-static view of integration. The main conclusion is that through the delays and difficulties of the integration process (i.e. resistance to changes on the part of national banking communities, asymmetries in the degree of integration of wholesale versus retail payments, slow diffusion of innovative payment instruments), a more realistic view of payment systems, as utilities for the financial sector, has finally emerged.

[1] All the authors are with the Bank of Italy. The opinions expressed are their own and do not necessarily reflect those of the Bank of Italy. Address correspondence to: paola.masi@bancaditalia.it

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I am now beginning to get fairly into my work; and by the help of a vegetable diet, with a few cold seeds, I make no doubt but I shall be able to go on, in a tolerable straight line.
(L. Sterne, Tristam Shandy, 1759)

1. Introduction

The way to the EU single internal market, a pillar of the Treaty of Rome (1957), was paved only in the 1980s with the Commission's White book on "completing the Internal Market". This gave rise to intense legislative activity continuing until 1992, and complete framework legislation for the creation of an extensive market, implying the development of economies of scale, competition and growth. Little or no attention was paid to matters of financial stability.

After the introduction of the single currency (1999) and following on developments in the financial sector, considerable advance has been made in the integration of payment and settlement systems, for both wholesale and retail transactions. However, the process still needs to be completed and the consequences of the recent economic crises seem to have damped down the momentum of and consensus on linear progress towards the economic integration in Europe. The impact of financial stability on the integration process can no longer be disregarded, and the costs of integration (required investment in infrastructures, increasing coordination costs, interdependencies, new practices and standards) cannot be ignored.

This paper retraces European policies and legislative measures aiming at integration in payment systems over the last two decades. The main phases of the process (launch of the single market, introduction of the euro, creation of the single euro payment area, aftermath of the 2008 crises) are identified through the adjustments and changes in the regulatory and economic approach adopted by the European institutions. The main conclusion is that through the delays and difficulties of the integration process (i.e. resistance to changes on the part of national banking communities, asymmetries in the degree of integration of wholesale versus retail payments, slow diffusion of innovative payment instruments), a more realistic view of payment systems, as utilities (like electricity, gas, etc.) for the financial sector, has finally emerged. As is already the case with the regulation of utilities of high public relevance, the recent strategy of European regulators includes the objectives of consumer protection, transparency, security and legal clarity.

The paper is organized as follows. In sections 2 and 3, we illustrate the creation of the single market in Europe and its economic rationale, with the

liberalization of cross-border operations for financial institutions, including the provision of banking services, and the policies followed by the European Commission and monetary authorities during the 1990s. At that time, there was total reliance on market forces to help the integration of payment services while policy action was limited to the integration of large-value payments, with a view to the adoption of the single currency and single monetary policy. Sections 4 and 5 illustrate how, after the introduction of the euro, disappointment with the state of cross-border integration, particularly for small value payments, drove the Commission to move actively in this field, being less confident in a pure "market-led" integration process; the steps toward the introduction of the SEPA are described. In sections 6 and 7, starting from the economic consequences of the financial crisis (a new fragmentation of national markets, the sharp decline of interbank transactions and payments), the new strategies and the state of the integration of payment systems are outlined. We conclude with section 8, where we try to draw some lessons from the overview presented in the paper, providing elements of interpretation of some key features concerning payment services and a possible line that policies should follow to complete the integration process.

2. The White Book of 1985 and payment in the internal market in 1990

The single market is the core of the process of European integration envisaged with the Treaty of Rome signed in 1957 and its aim is to guarantee in Europe the free movement of people, goods, capital and services. The latter concerns the freedom for providers of services, including financial and payment services, to conduct their business in all member states. The free movement of capital and payments implies that capital controls and restrictions on currency movements are abolished and the supply of foreign financial services providers across the borders is made easier. Overall, the aim of economic integration is to provide citizens and companies with access to markets previously closed by national barriers.

The European economic integration started with a free trade agreement, abolishing custom duties and tariff trade barriers. However, the single market represents a much deeper level of integration by far, as it also aims at ruling out 'non-tariff barriers' that may reflect different legal and technical standards, often justified for health and safety reasons or for environmental or consumer protection.

The cornerstone of the European single market was the Commission's White Paper presented to the European Council in June 1985[2], with a view to achieving a thorough single market by 1992. This was endorsed by the then 10 member states with the European Single Act of 1986. These initiatives gave rise to an intense acceleration of the legislative activity, with almost 300 Commission's proposals for directives in the following years ahead of the set deadline of end 1992.

The European Commission conducted analysis of the potential impact of the single market. An important and much-quoted assessment was the so-called Cecchini report of 1988[3]. The results of the analysis showed a significant wealth effect of above 40% cumulated over a period of 5 to 6 years, i.e. an annual increase of GDP estimated between 4.5 and 6.5% for the twelve member states of that period. It calculated a potential price reduction by some 6%, due to competitive pressures, as well as the creation of two million new jobs. A number of analysis estimated that the expectations of the Cecchini report were overly optimistic[4]; however it is mostly agreed that the introduction of the single market had a positive impact on growth[5]

From the very beginning of the integration process, the sector of payments was considered an integral part of the more general financial sector. In 1990, the Commission issued a first document on 'making payments in internal market'[6], assuming that the benefits of the internal market will only be realised if cross-frontier payments operate as effectively as those at national level. In the Commission's view, the roadmap for the transition to a single currency should have been increasingly integrated with improvements to cross-border payment systems within the internal market, although they represented only 1% of total transactions in Europe as reported by the same document. The Commission was expecting a rapid increase in cross-border transactions and estimated the number of retail cross-border payments at 400 million each year up to the end of the century. At that stage, the Commission was aware of the peculiarities of the payment sector and of the extensive efforts needed to create new European standards and infrastructures with the cooperation between

[2] EU COMMISSION, *Completing the Internal Market. White Paper from the Commission to the European Council*, 28-29 June 1985. COM (1985) 310 final.

[3] CECCHINI – CATINAT – JACQUEMIN, *The European challenge 1992: the benefits of a Single Market*, 1988, Gower: UK.

[4] For example, a study presented in 1994 (Harrison, 1994) quantified the effect at just 0.5% of the European GDP or, including the long-term effects, at 1.2%.

[5] An assessment of 2007 by the European Commission and other estimates found that it had generated additional income of nearly above 2% per year between 1992 and 2006.

[6] EU COMMISSION, *Making Payments in the internal market*, 26 September 1990. SEC (1990) final.

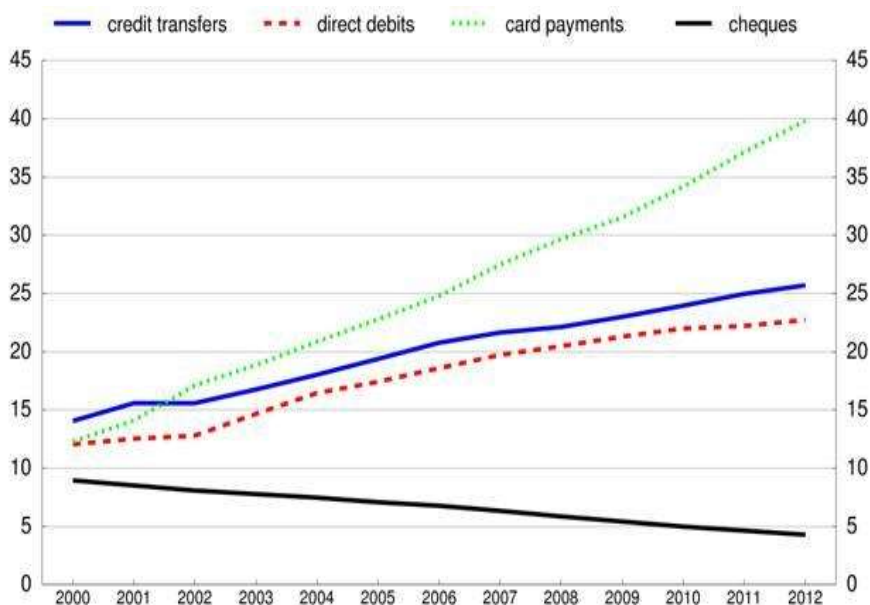
banks and other institutions of the financial sector. However, full reliance on competition and on the incentives provided by the openness of the single market was not questioned.The Commission intended to be a catalyser of the process, i.e. listing the possible solutions to the lack of a European Automated Clearing House (EACH), while underlining the potential benefits for non-financial institutions (i.e. retail customers, SMEs, corporates, public administrations) of an integrated retail payments market.

In the same perspective, in a working document of 1992 the Commission laid down a detailed programme of work for the financial sector in the area of payment systems, taking into account all aspects involved in a cross-border transfer in Europe, namely costs and prices, time of execution, technical standards, characteristics of payment instruments, clearing and settlement services, membership rules, information to customers, statistical reporting and legal framework[7]. As for the payment instruments to be used in cross-border transactions, the Commission did not aim directly at harmonizing the different payments habits of the member states, nor at fostering the use of non-cash electronic payments. At that time, the composition of non-cash payments by instruments (cheques, credit transfers, other) in most EU member states showed the dominance of cheques (63% of total in FR, 49% in Italy, 55% in UK, 31% in Belgium, but only 9% in DE). In the following years, the trend in the composition of mostly used payment instruments was very different: credit transfers and direct debits prevailed as rules and standards of such payments were easier to be harmonized than those of cheques[8].

[7] EU COMMISSION, *Easier cross-border payments: breaking down the barriers*, 27 March 1992. SEC (1002) 621 final.

[8] See: Chart A, Table 1.

Chart A: Use of the main payment instruments in the EU (2000-2012)
(number of transactions per year in billions, estimated)



Source: ECB, Blue Book, 2013

3. The economic rational of the Single Market

From a theoretical perspective, the single market was expected to provide significant welfare gains and stimulus to innovation. Through the creation of an EU-wide free-exchange area, the European economy in all sectors would have benefited from large economies of scale, increased competition and extended price reductions, which in turn would have enhanced investment, growth and employment. Hence, the removal of barriers to free movement of economic resources would have led automatically to market integration and economic convergence among member states. The costs and the possible drawbacks of integration, in particular the vulnerabilities related to financial interdependencies which may affect financial stability, were not investigated.

Extended cost reductions were envisaged via the harmonization of production and quality standards, enabling to easily sell products within the European market. A wider market was thought of as conducive to possible

economies of scale for companies, particularly in sectors with high fixed costs, as they would have also optimized production processes via cross-border merger and acquisitions. Competition should have increased, due to lower entry barriers, while inefficient companies would have been put under pressure by more efficient competitors. This would have reduced the mark-ups in protected markets, bringing about price convergence throughout Europe and the cost advantage would have partly passed on to consumers. Finally, financial market integration and liberalization would have made financial transactions easier and cheaper; benefits of financial integration were thought to come from improved allocative efficiency. Given the high level of cross-border activities, the financial and monetary markets were expected to profit more than other sectors from the removal of national barriers to monetary transactions.

The European single market was introduced at a time where the international context was primarily supporting the progressive development of market-friendly financial supervision and financial regulation, implying the dismantling of a system of structural controls of financial institutions. A full-fledged system of prudential regulation was introduced for financial markets and institutions, where a set of rules, such as those agreed in Europe with the creation of the single market and mostly based on the recommendations of the Basel Committee of Banking Supervision, constituted basic requirements, while allowing financial institutions to operate without any structural constraints. The system of universal banking fully developed from this legislative framework. Within this context, the large European single market was oriented towards opening competition since its origin, i.e. to the full use of market forces, as this was enhanced by the possibility for financial institutions to operate cross-border. The European Commission was tasked with fostering competition making use of competition rules set out in the Treaty and that also applied to the banking sector.

In order to accelerate the 'natural' convergence to the single market by the different member states, the Commission adopted a regulatory approach based on the principle of "minimum harmonisation" and "mutual recognition", i.e. member states should recognize foreign national regulations concerning goods and services across borders, while respecting some basic requirements.[9] The trade-off between the time and the contents of the harmonization of the economic infrastructures in member states was solved pragmatically laying down essential requirements, compulsory in all member states: the fulfilment

[9] The principle of mutual recognition first entered into Community law following the sentence of the European Court of Justice of 1979 known as the case *Cassis de Dijon*.

of such requirements entitled products and services to free movement. The compliance with minimum requirements draws a clear distinction between what needs to be harmonised and what may be left to mutual recognition of different national regulations and standards.

The new legislation in the banking and financial sector followed such principle of mutual recognition: it introduced the European passport or single banking license, allowing a financial institution authorized in one member state to open branches or provide services cross-border in all other member states on the basis of the so-called home country control.

In the field of payment systems, the regulatory approach followed a different path for retail payment systems and for large-value ones. Since large-value infrastructures were designed for wholesale payments (including monetary policy operations) mostly consisting of interbank operations or treasury and currency transactions of large enterprises, a set of minimum harmonised features were defined only for large value payment systems. In September 1992, the Working Group on EU payment Systems, a group formed by EC central banks, under the lead of Tommaso Padoa Schioppa, identified the issues of common concern for central bankers in the field of payment systems. In November 1993 the report *Minimum Common Features for Domestic Payments Systems* fixed «the harmonisation of some of the main features of the large-value interbank funds transfer systems (IFIS)»[10]. Building on that report, the decision was taken by the Council of the European Monetary Institute (EMI) in March 1995 to link each national Real Time Gross Settlement (RTGS) system in order to have a cross-border RTGS system ready by the start of the EMU. The result was the Trans-European Automated Real-time Gross settlement Express Transfer (TARGET) system that successfully started its operations on 4 January 1999. The decision of the EMI Council was crucial for the developments of the infrastructures needed for large value payments to accompany the introduction of the single monetary policy and the monetary union. However, as similar policies were not undertaken for the whole of the infrastructures and for the retail sector, it also

[10] Report to the Committee of Governors of the Central Banks of the Member States of the European Economic Community on *Minimum Common Features for Domestic Payment Systems* prepared by the Working Group on EC Payment Systems, November 1993. The report established 10 principles covering the following areas that required specification in terms of minimum common features: access conditions, risk management policies, legal issues, standards and infrastructures, pricing policies and business hours. As a follow-up to the publication of the report and as a way to further reduce risk, EU central banks commonly decided that an RTGS system should be set up in each EU country for the relevant national currency.

contributed to delay the integration of retail payment systems in the EU. For the retail sector, up to the first direct intervention in 1997 with the proposal on cross-border credit transfers[11], the European Commission relied on recommendations to the banking industry, while waiting for the positive outcomes of the incentives provided with the principles of the single market. So, basically, the Commission, and also the monetary authorities, waited for the banks to find solutions to the peculiarities of payment systems, especially of the payment facilities to be used by retailers and end-users, and in particular to bear the burden and the high fixed costs for new infrastructures, prompting a quick integration of the different national systems. Indeed, the role of payment systems as utilities[12], as well as the degree of market power of incumbent financial institutions operating in this field, was totally underestimated.

4. The EURO and the law of 'one price'

Article 109j(4) of the Treaty establishing the European Community sets out the 1st of January 1999 as the latest date for the beginning of stage III of Economic and Monetary Union, with a single currency and a single monetary policy.

In 1999, the Commission communication on the implementation of the framework for financial services, known as the Action plan[13], was the opportunity to stress that, despite the important steps taken towards the construction of the single market and the introduction of the euro, European financial markets remained segmented. Indeed, businesses and, above all, consumers continued to be deprived from direct access to cross-border financial institutions. The Commission highlighted in particular that fundamental changes in the EU financial markets were driven by wholesale services and instruments, whose price differentials dropped with the single currency while users and suppliers of retail financial services were not able to take advantage of the commercial opportunities offered by the single market. Prices of main financial assets converged significantly (e.g. Chart B), Therefore, there was a case to take initiatives for retail services, while ensuring consumer protection. Special reference was made to low value credit transfers

[11] It was then adopted as Directive 97/5 on Cross Border Credit Transfers.

[12] BERNANKE, *Clearinghouses, Financial Stability and Financial Reform, Remarks at the 2011 Financial Market Conferences,* FRBA, Georgia, April 2011.

[13] EU Commission, Financial Services, Implementing the framework for Financial Markets: Action Plan. 11 May 1999. COM (1999) 232.

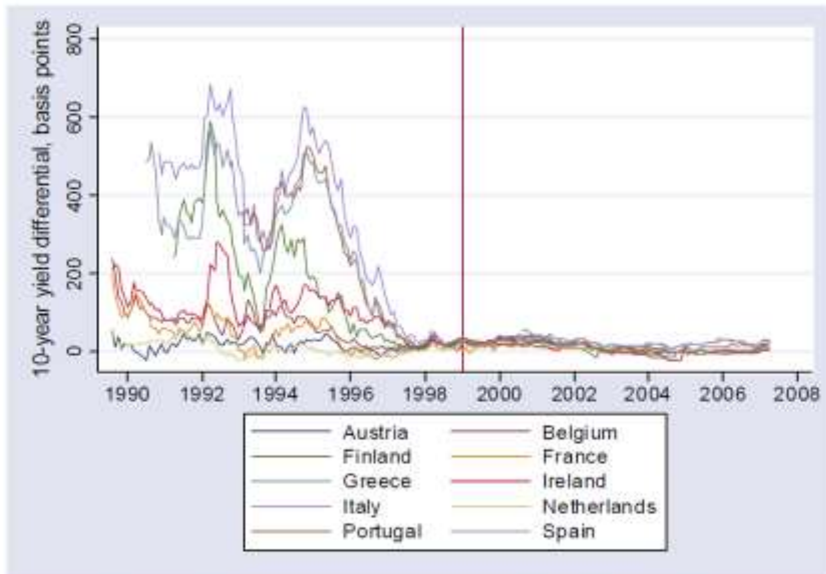
between EU countries that continued to attract very high charges. Likewise, charges for cross-border card payments were higher, and often much less transparent, than fees for domestic card payments. In 2000, another Communication[14] set the date of January 2002 as deadline to provide solutions for enhancing the efficiency of cross-border payments - by cutting charges towards the level of domestic credit transfers- and invited banks and groups of banks to put forward specific proposals in this direction. Banks were also encouraged to implement the IBAN and other technical standards, as well as ensuring interoperability for electronic means of payments. The Commission, in cooperation with the ESCB, would have assessed whether banks' proposals were satisfactory and in case solutions were not considered sufficient, it would have taken appropriate legislative initiatives to overcome the inefficiencies.

Only in 2002 with the introduction of the euro as single currency, the need to impose the "law of one price" for similar products in domestic and cross border payments was definitely clear[15]. Regulation 2560/2001 of 19 December 2001 marked a turning point in the European policy stance in promoting the internal market and was a 'slap in the face' to the EU banking community's resistance toward integration. The EC Regulation 2560/2001 established the principle of equality of charges for payments within member states (national) and across the borders. The Regulation applied to ATM cash withdrawals and purchases by payment card since July 2002 and to credit transfers since July 2003. The base principles enshrined within the Regulation were the non-discrimination between corresponding national and cross-border payments made in euro on the basis of price and the requirement on banks to provide customers with readily comprehensible ex-ante information on charges levied for affected payments.

[14] EU Commission, Communication on Retail Payments in the Internal Market. 31 January 2000. COM (2000) 36 final.

[15] Jappelli and Pagano write: «Financial markets are integrated when the law of one price holds», in JAPPELLI – PAGANO, *Financial Market Integration under EMU*, CSEF Paper n. 197, 2008.

Chart B 10-years benchmark bond yield spreads before and after the EMU. 1990-2007



Note: Yield differentials are computed relative to the yield on the benchmark German 10-year Bund, based on monthly data (end-of-month observations). Source: Datastream.

Source: Jappelli and Pagano (2008)

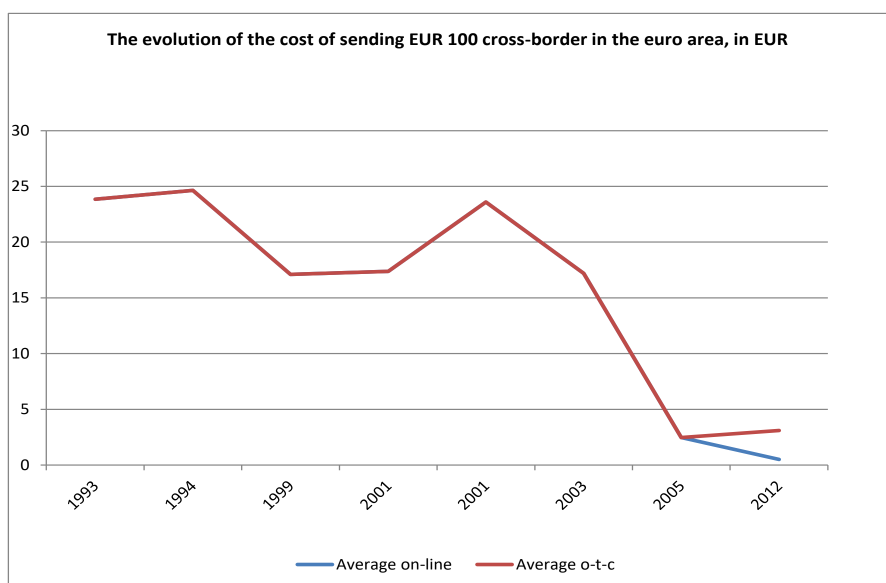
When it was adopted, the Regulation raised vigorous opposition from the banking sector, because of its perceived "price-fixing" nature. The main argument was that the number of cross-border payments was small (indeed it is still the 3% of the total transactions) in comparison to national payments, and that the consequence of the Regulation would be to increase national prices, which happened in some cases (e.g. LUX, BE, GR, FR, IT, SP, PT, see Table 2).

However, based on the several studies on costs of cross-border credit transfers by the European Commission, Regulation 2560/2001 was a success and finally able to reduce the price of cross-border payments (Table 3): the charges for a EUR 100 transfer costing the consumer on average EUR 24 in 1993, after the introduction of the Regulation, were dramatically reduced to less than EUR 2.00 (see Chart C).

From that period on the European institutions recognized that the integration of the payment systems in the EU would not have developed

through self-regulation promoted by banks, but there was instead the need for regulatory and legislative initiatives[16]. However, outside the perimeter of the European System of Central Banks[17], the economic reasons for such a huge difference in the costs of cross-border transactions were not fully debated and the fact that payment infrastructures are a network industry based on standards, externalities and high fixed costs, was not generally understood.

Chart C – Results of the European Commission surveys on the costs of cross border transactions in internal market. 1993- 2013.



Source: European Commission (2006); London Economics (2013)

[16] Meanwhile, the Commission continued to sustain the integration of capital markets, in particular of securities clearing and settlement systems where the costs of post-trade services across border had remained high compared to domestic costs. See the two reports of the GIOVANNINI GROUP, *Cross-Border Clearing and Settlement Arrangements in the European Union*, November 2001; GIOVANNINI GROUP, *Second Report on EU Clearing and Settlement Arrangements*, April 2003.

[17] For an example of awareness, see the arguments around the role of the ECB as overseer of the payment and settlement system in European Central Bank. See: ECB, *Eurosystem oversight policy*, July 2011.

5. The age of SEPA

Retrospectively, Regulation 2560/2001 could be considered also as the kick-off of the Single Euro Payments Area (SEPA), that is the area in which consumers, companies and other economic actors can make and receive payments in euro, whether between or within national boundaries under the same basic conditions, rights and obligations, regardless of their location. For the first time, the process of integration in retail payments directly involved domestic schemes and instruments and not only cross-border transactions. In fact, the Regulation encouraged the European banking industry to create the European Payments Council (EPC) in June 2002 with the aim to define and manage an EU-wide, integrated payment infrastructure for retail payments setting open and common industry standards for core payment instruments, like credit transfers and direct debits. Self-defined standards and rules by the industry was expected to deliver the SEPA project by 2010[18].

However, and in support of the industry commitment, the European Commission intervened again to set the legal basis for the SEPA, mainly with a proposal that was finally adopted in 2007 as the Payment Services Directive (PSD)[19] implemented by all Member States by 1 November 2009. The PSD extended the idea of same rules for same payments to all electronic payment instruments in the European Union while addressing the improvement of competition, efficiency and cost-reduction, also by opening up payment markets to new entrants (payment service providers) (Table 3)[20].

According to the European Commission, a successful implementation of the SEPA project could save the EU economy between €50 and €100 billion per year[21] . From the launch of the project, the ECB has acted as a catalyst, providing analytical work and producing progress reports, together with the national central banks, as well as organising conferences and other events to bring market participants together. Nevertheless the governance of the project by the European banking industry faced several 'coordination problems',

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[18] Although related to euro denominated transactions, the single euro payments area is covering the 28 EU Member States, plus Iceland, Norway, Liechtenstein, Monaco, Switzerland and San Marino).

[19] Directive 2007/64/EC – Payment services in the internal market Directive on Payment Services (PSD).

[20] The efforts by the European Commission to cut the costs of the other components of cross-border transfers for consumer - namely on the maximum time allowed for settling a cross-border transaction and on the interbank practice of "double-charging" of fees – dated back to 1990.

[21] See: EU Commission, Time to Move Up A Gear. 2006 Annual Progress Report on Growth and Jobs at: http://europa.eu.int/growthandjobs/pdf/2006_annual_report_full_en.pdf

mainly related to the difficulties to accommodate the diverse requirements of national banking communities.

The SEPA Rulebooks set European standards for basic retail payments, i.e. SEPA credit transfers and direct debits, and helped to reach some concrete achievements:

- Pan-European schemes were introduced by the payments industry in January 2008 and November 2009 respectively;
- costs for cross-border payments are the same as for national payments;
- the execution time for a credit transfer does not take more than one banking day (D+1);
- multi-country corporates no longer need a payment service provider in each of the countries in which they are active, but have started to consolidate their handling of payment flows in euro and related treasury services, hence reducing operational complexity and increasing competition in corporate banking.

As for the payments infrastructure to handle and settle SEPA payments, the project aimed to guarantee the reachability of all European citizens with a full geographical coverage in Europe, through the creation of a PAN-European Automated Clearing House (PEACH) or the links of national ACHs. In 1992 there were about 60 EU domestic payment systems in the European Union. Banks that operate in different member states needed to adapt to those 60 different procedures and technical standards. The domestic automated clearing houses (ACHs) of the Member States did not communicate with each other and cross border transfers had to be processed through the rather time and cost-consuming channel of correspondent banking, based on bilateral relationships between financial institutions. The creation of a PEACH was sponsored by a bank-owned provider of European payment infrastructure solutions[22] while the process of consolidation among the national ACHs started – in 2014 the "SEPA compliant" ACHs are 30 -. However the market-led process of consolidation of retail payment infrastructures was very slow and different from the authority-led consolidation of large-value payment systems, which in the same years evolved and drew a second generation of

[22] The STEP2 system, managed by EBA Clearing. Indeed the system started to operate even before the definition of rulebooks. The first STEP2 service was launched in April 2003 for processing credit transfers that are compliant with the convention on credit transfers in euro, i.e. retail payments of up to 50,000 euro per transaction, in accordance with the requirements of EC Regulation 2560/2001, which was superseded by EC Regulation 924/2009.

single infrastructures (like TARGET2 which replaced the previous one in May 2008)[23].

Although fully supported by the Commission, the European Central Bank and the member states, the implementation of the SEPA project was harder than expected. The coordination problems among the European banking industry halted the speed of definition and adoption of standards for SEPA basic payment instruments (credit transfers and direct debit) and value added services and for the full interoperability of European payment infrastructures. Once again, the end-date of the project (1st August 2014), that is the final substitution of domestic procedures with the European ones, was imposed by regulations (EU Regulation 260/2012 and EU Regulation 248/2014).

6. The aftermath of 2008

At the beginning of the last decade and before 2008, in EU wholesale activities and all transactions between financial institutions presented an extremely high degree of integration. (Chart D). Spreads registered on interbank European markets became practically identical immediately after the introduction of the single currency. The payment infrastructure for wholesale payments was almost fully integrated. Moreover, bond issuances by large companies on international markets were higher than domestic issuances. Asset management activity and trading were concentrated and diversified at European and international level, thus benefiting from significant economies of scope and scale. In 2004, about 30% of the banking sector was owned by non-resident banks, with a considerable increase from the previous decade, following an intensification of mergers and acquisitions. In 2007, almost 40% of the euro area interbank claims were vis-à-vis non-domestic banks in the EU. Cross-border holdings in bond markets accounted for 54% of total holdings of EU bonds[24].

[23] Similarly to its predecessor, TARGET2 is used for the settlement of payments connected with monetary policy operations, of interbank payments and of transactions related to other payment and securities settlement systems (i.e. ancillary systems). The previuos version had a decentralised technical structure, consisting of 17 national RTGS systems and the ECB payment mechanism, and was available for credit transfers in the countries that had adopted the euro as their currency. TARGET2 offers a technically integrated platform, harmonised services at the EU level and a single pricing structure. It provides ancillary systems with a harmonised set of cash – settlement services. The new single platform was explicitly aimed to lower costs.

[24] IMF, *Financial Integration and Fragmentation in the European Union*, IMF Country Report n. 1371, March 2013.

Overall, a large European financial industry had emerged[25], also thanks to the opportunities created at the EU level, that were particularly advantageous to large companies and banks. Indeed, the integration in the euro area and in the EU advanced in wholesale funding markets and bond markets, while retail lending markets remained mostly national. The integration of EU local banking markets remained low, especially compared to what happened in the U.S. following the interstate deregulation in the 1980s[26].

The road to integration was halted by the 2008 crisis. This triggered a reversal of the integration process, reinforced by the sovereign debt crisis within the euro area and the related perverse bank-sovereign feedback loop. The result was a trend towards fragmentation and re-nationalization of the financial systems in the EU (Chart E). BIS data indicate that gross consolidated foreign claims of euro area banks decreased by 35% from 2008 and 2012, returning to the level of 2005[27].

The process of integration of payment systems slowed down considerably, together with the shrinking of payment transactions, and despite the decisive impulse provided by the legislation since the beginning of the decade[28].

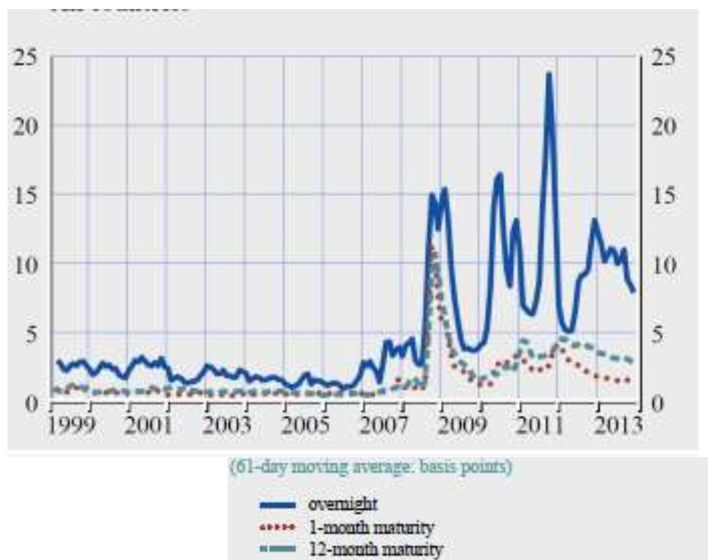
[25] PADOA SCHIOPPA, *Regulating Finance. Balancing Freedom and Risk*, Oxford University Press, 2004.

[26] IMF, *Financial Integration and Fragmentation in the European Union*, IMF Country Report n. 1371, March 2013.

[27] BOLOGNA – CACCAVAIO, *Euro Area (cross-border?) Banking*, Bank of Italy, Occasional Paper 2014.

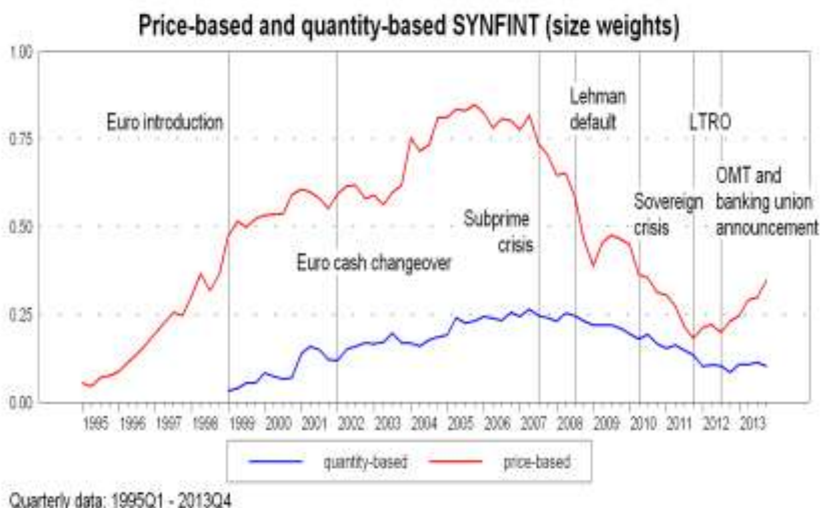
[28] PAGANO, *Dealing with Financial Crises: how much help from research?*, CSEF Working Paper n. 361, May 2014.

Chart D Cross country standard deviation of average usecured interbank lending rates (*)



(*) AT,BE,DE,ES,FI,FR,GR,IE,IT,LU,NL.PT.
Source: ECB, Financial Integration in Europe, April 2014

Chart E - Overall developments in financial integration(*)



(*) SYNFINT index with 1= full integration and 0=total fragmentation.
Source: European Central Bank (2014)

The velocity of circulation of retail transactions decreased sharply after the 2008: the value of total payment transactions that was 20 times GDP in 2008 for the EU area decreased to 18 times in 2009 and it is still at the same level; in the Euro area, the ratio was 15 times in 2008 and it is still the same now. The same ratio for large value transactions in TARGET2 (which was 75 times GDP in 2012) and in the multi-currency settlement systems of foreign exchange trades did not follow the same path, showing a decrease only in 2009. This was the occasion to start a deeper analysis of what was needed to regain momentum and also to form a critical view on the approaches by the European authorities to the payment systems integrations.

In this perspective, the aftermath of 2008 had the positive outcome of highlighting some weaknesses in the analytical background of the integration process. In fact, although market infrastructures have generally functioned well during the crises, some events, especially the default of Lehman Brothers in September 2008 and the dynamics of sovereign debt crises, showed the ‘negative’ side of integration and its potential dangerous effects on financial stability. In particular:

- a single integrated market usually has a high level of interconnection of payments, clearing and settlement systems, also through common

participants or common service providers. This may produce contagion, which require a strong commitment to cooperation and information sharing also on micro-aspects, as well as common knowledge of administrative rules (i.e. default procedures) among national communities. It also requires an enhanced system of supervision;

- the coexistence of integrated areas of the economy with fragmented markets might affect financial stability. «While euro area interbank markets became almost completely integrated, retail banking integration remained largely fragmented»[29]. This meant that when the crisis hit, the cost of repairing banks' balance sheets fell largely on their domestic fiscal authorities. «The result was the infamous bank-sovereign nexus that has perpetuated financial fragmentation in the euro area»[30];
- the integration of market and payment infrastructures is not sufficient if monetary transactions (innovative payment instruments, or schemes) and new financial instruments are traded and settled off of them. Commitments were taken in this regard by the G20 at global level in 2009 and the Financial Stability Board was tasked with implementing a reform of OTC derivatives markets in order to achieve consistency across jurisdictions, avoid regulatory arbitrage and promote greater standardization of derivatives products[31];
- the lack of integrated retail payments and markets imposes higher costs on retail clients (SMEs, citizens, public administrations) than on payment service providers, which are reluctant to invest in infrastructures and innovative payment instruments.

Besides the profound institutional changes started with the design of the single supervisory mechanism, European authorities, and in particular central banks, increased the efforts to monitor and control inefficiencies in the design

[29] Financial Integration in Europe, European Central Bank, April 2008.

[30] DRAGHI, Financial Integration and Banking Union'. Speech by Mario Draghi, President of the ECB, at the conference for the 20th anniversary of the establishment of the European Monetary Institute, Brussels, 12 February 2014.

[31] FINANCIAL STABILITY BOARD, *Implementing OTC Derivatives Market Reform*, 25 October 2010. Based on a Commission proposal of 2010, the Regulation 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (also referred to as the European Market Infrastructure Regulation (EMIR)) entered into force in August 2012. Moreover, on 7 March 2012, the European Commission issued a proposal for a regulation «on improving securities settlement in the European Union and on central securities depositories (CSDs)». The Central Securities Depository Regulation (CSDR) Regulation (EU) No 909/2014, entered into force on 17 September 2014, establishes an EU framework for the authorisation, supervision, cross-border service provision and outsourcing to a public entity, as well as prudential and organisational requirements for CSDs.

of pre and post-trading infrastructures, in the allocation of costs between financial intermediaries and their clients, in the pricing or management of financial risks. Monetary authorities shared the awareness of the "robust-yet-fragile" nature of financial networks: the same features that make the system more resilient under certain conditions may function as significant sources of systemic risk and instability under another[32] .

In the retail payment systems, the catalyst role of ESCB toward the SEPA project was extended to include the promotion of electronic payments, an adequate governance of the project, efficient cooperation among authorities and transparency of the costs of payment instruments[33].

7. The integration of payment and retail banking services: the recent strategy

A new report on possible ways to enhance the single market was presented to the President of the European Commission by a task force chaired by Mario Monti in May 2010[34].

The report highlighted that the single market was at a critical juncture, facing the challenge of the reduced support for market integration and the fact that the objectives enshrined in the White Book of 1985 and in the Single Act were not achieved, particularly referring to the incomplete "welding together" of the national markets, to the missed expansion of the principles to a number of new sectors and to the unfinished work to ensure that the single market is a space of opportunity for all, including citizens, consumers and SMEs. It also stressed that corporatism and rent-seeking were still keeping domestic economies partly sheltered from the full play of the single market and from competition, preventing the needed improvements. The main conclusion was that the single market had so far been to the advantage of big businesses, but had not worked for the many and the small, i.e. citizens, consumers and SMEs. On the same lines, the so-called Lamassoure report of 2008[35] on the application of Community law concluded that «creating a single space for

[32] See ACEMOGLU – OZDAGLAR – TAHBAZ-SALEBI, *Systemic Risk and Stability in Financial Networks*, MIT Department of Economics, Working Paper Series, January 2013.

[33] For the latter, see ECB, *The Social and private costs of retail payment instruments. A European View*, Occasional Paper 2012 n. 137.

[34] MONTI, *A new strategy for the Single Market. Report to the President of the European Commission*, 9 May 2010.

[35] LAMASSOURE, *Report o "The Citizen and the Application of Community Law".Report to the President of the Republic*, 2008.

citizens is still at the stage before the Single European Act of 1986». Among a number of other recommendations to ensure a better functioning of the single market, also in the perspective of citizens, consumers and SMEs, the Monti report called for accelerating the integration of retail banking services, with a particular emphasis on retail payment services.

The new strategy of the European regulators with regard to payment providers and services developed along three lines:

- removing the obstacles to cross-border retail banking services through improved transparency of bank fees, enhancing customer mobility, reduction of the costs of bank account switching, ensuring the availability of standardised and comparable information for retail financial products and defining a number of basic banking services, affordable to all European citizens;
- acting vigorously with the power of the Competition rules - laid down in the Treaty [36]- on payment instruments, launching studies and opening cases in the area of card payments in order to avoid anti-competitive trade practices[37];
- promoting innovation in payment instruments, filling the gap created by existing innovative payments, such as mobile and digital payment services, while defining minimum security requirements.

It seems evident that EU authorities are currently aimed at playing a fully active role in the process, through legislative measures and policies, with a view to achieving concrete results in terms of efficiency for the whole economic system, while safeguarding consumer protection.

As for the cross-border retail banking services, already in 2007, the Commission conducted an in-depth investigation in the whole sector of retail banking and payments[38], which represents the most important sub-sector of

[36] Reference should be made to the Treaty on the Functioning of the European Union, Common Rules on Competition, Taxation and Approximation of Laws, Title VII, as well as to EU Commission, Regulation EC/1/2003 of 16 December 2002 on the implementation of rules laid down in articles 81 and 82 of the Treaty, 2003, particularly art. 17.

[37] An overview of such activity by the ECN Subgroup Banking and Payments within the European Competition Network in March 2012. European Competition Network (2012). The main competition concerns in the area of card payments are: the existence and the discrepancy in multilateral interchange fees across member states; the exercise of a significant market power by incumbent banks and brand owners in payment card networks; the prevailing of membership rules and governance arrangements in networks that may limit the participation of new competitors; preferential bilateral fee agreements; different classes of membership for the access to clearing houses or different national standards.

[38] EU COMMISSION, *Sector Inquiry under Article 17 of Regulation EC n. 1/2003 on retail banking (Final Report)*, 31 January 2007. COM (2007) 33 final.

banking (over 50% of total EU activity). The Commission estimated that retail banking generated gross income to banks equivalent to approximately 2% of EU GDP; the inquiry showed a wide variety of profit margins, prices and selling patters between the member states, while there was instead evidence of convergence within individual states; a number of possible barriers to entry, in relation to regulatory issues or standardisation requirements for certain infrastructures; the existence of certain types of cooperation (such as the operation of platforms) could lead to collusion and limit competition. Surveys conducted in 2012, including the Eurobarometer of the European Commission[39], reached the following conclusions on payment services: most consumers tend to remain attached to their payment providers and only a low percentage (16%) had opened a new payment account in the previous years; only 3% of the respondents had opened an account cross-border, as consumers were dissuaded by unclear information, lack of clarity on their rights and complex processes; EU citizens had experienced difficulties in opening a payment account in a member state where they work, but do not have a permanent address.

The Single Market Act II[40] of the Commission dated 2012 identified, among other priorities, a legislative initiative on bank accounts aimed at giving all EU citizens access to a basic payment account, ensuring bank account fees that are transparent and comparable and making switching of bank accounts easier. The Commission issued a proposal for a Directive[41] to overcome some of these issues, which was adopted by the European Parliament and the Council in the spring 2014.

A new Commission proposal providing adjustments to the existing PSD adopted in 2007 has now the objective of modernising the existing legislative framework[42]. A further example of the new line taken by the European institutions, now aimed to promote fair pricing of most used payment instruments, is reflected in the Commission's proposed Regulation on

[39] EU COMMISSION, *Standard Eurobarometer 78. Public Opinion in the European Union*, Autumn 2012.

[40] EU COMMISSION, *Communication from the Commission. Single Market Act. Together for new growth*, 3 October 2012. COM (2012) 573.

[41] EU COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on the compatibility of fees related to payment accounts, payment account switching and access to payment accounts with basic features*, 8 May 2013. COM (2013) 266 final.

[42] EU COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2913/36/EU and 2009/110/EC and repealing Directive 2007/64/EC*. COM (2013) 547 final.

interchange fees for card-based payment transactions[43]. Multilateral interchange fees are applied in four party card schemes to acquiring payment service providers and then passed on to merchants and consumers. As it has been assessed that such rules and practices seem to lead to inefficient pricing, fragmentation and reduced transparency, the proposal has the objective to regulate the use interchange fees more strictly, including with the capping of fees.

8. What have we learned?

Integration in payment systems is not a simple, automatic and linear process. The removal of barriers to free movements of services as the first (and, for a long time, only) approach adopted by regulators to integration for payment services, expecting competition to lead to gains in efficiency, stable economic growth and better services, belied expectations. The belief that markets were able to move towards integration autonomously via a self-regulatory process thus caused delay in the development of an EU integrated retail payment system.

Despite the ESCBs' awareness of financial risks and the European Antitrust authorities' knowledge of the relevant markets, the advent of the 'single' currency paradoxically perpetuated the illusion of an automatic convergence to the 'single' market. In the vast majority of cases, the European integration process was analysed for its positive impacts on European economies and not in terms of its costs (required investment in infrastructures, increasing coordination costs, interdependencies, new practices and standards). The European institutions intervened to speed up the process but no other correction of the market imperfections was judged necessary.

The financial crises required immediate and pragmatic adjustment both in the regulatory approach and in the economic narrative on payments infrastructures, and in particular their efficiency and reliability. Macroprudential policies to address vulnerabilities and risks in the financial markets called for deeper and more accurate analysis of single market structures, with the same objective but different tools and increased cooperation among authorities. The recent strategy of the European authorities now seems to share a common and more realistic view of the payment industry, and may well deliver a more robust integration.

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[43] EU COMMISSION, *Proposal for a Regulation on interchange fees for card-based payment transactions*, 24 July 2013. COM (2013) 550 final.

Payment service infrastructures are utilities for the efficient working of the economy, but depend on standards accepted by all the stakeholders in the payment cycle and bear high fixed costs in a context where the increasing interdependency of markets and systems may affect financial stability. The market structure of the payment industry does not incentivise the incumbent payment service providers and their networks, enjoying considerable market power and 'monopolistic-like' profits, to innovate and compete.

As is already the case with the management of utilities of great public importance, payment services and payment infrastructures should be regulated by authorities, both national and European, and should be subject to appropriate technical standards. The latter need to be in line with objectives of consumer protection, including downward convergence of costs and optimization for end-users, as well as criteria to ensure security, transparency and legal clarity.

MAIN EUROPEAN LEGISLATION ON PAYMENT SERVICES

Directive 97/5/EC on cross-border credit transfers

Directive 98/26/EC– Settlement finality in payment and securities systems

Regulation (EC) No 2560/2001 – Cross-border payments in euro

Regulation (EC) No 1781/2006 – Information on the payer accompanying transfers of funds

Directive 2007/64/EC – Payment services in the internal market Directive on Payment Services (PSD)

Decision 2009/72/EC – Payment Systems Market Expert Group (PSMEG)

Directive 2009/110/EC on the business of e-money institutions

Regulation (EC) No 924/2009 – Cross-border payments in the Community

Recommendation - (COM) 2011/4977 – Access of basic payment accounts

Regulation(EU) No. 260/2012 – Technical and business requirements for credit transfers and direct debits in euro

Regulation (EU) No. 248/2014– amending Regulation (EU) No 260/2012 as regards the migration to Union-wide credit transfers and direct debits (SEPA end-date)

Directive 2014/92/EU - on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features

Table 1 - The composition of payment instruments in 2012

Country	All payments		Cash payments			
	Volume Percentage of EU27	*Value* Percentage of EU27	*Volume* Percentage of EU27	*Value* Percentage of EU27	*Volume* Percentage of all payments in each country	*Value* Percentage of all payments in each country
Denmark	1,03	0,32	0,61	0,57	37,39	2,26
Estonia	0,22	0,06	0,15	0,10	44,16	2,19
Finland	1,25	1,86	0,76	1,02	36,06	0,70
Greece	2,39	0,54	3,63	3,71	96,61	8,77
Hungary	1,46	0,77	1,71	1,00	72,79	1,64
Ireland	1,03	0,39	1,13	1,31	69,07	4,24
Italy	12,89	4,28	17,51	18,13	86,27	5,40
Latvia	0,32	0,15	0,36	0,19	67,74	1,57
Netherlands	3,55	2,55	2,12	2,53	36,95	1,26
Portugal	1,71	0,79	1,58	1,09	57,91	1,77
Romania	2,59	0,53	3,87	1,59	93,39	3,82
Spain	9,62	5,55	11,27	11,77	74,24	2,70
Sweden	2,05	0,53	1,26	1,47	38,29	3,56
Austria	2,26	1,02	2,02	2,77	52,52	3,48
Belgium	2,23	1,81	1,92	2,04	54,42	1,43
Bulgaria	0,86	0,06	1,31	0,44	94,61	9,87
Cyprus	0,17	0,18	0,21	0,22	77,35	1,53
Czech Republic	1,64	0,93	2,00	1,39	76,89	1,91
France	13,02	10,64	9,11	9,81	44,15	1,17
Germany	19,54	28,55	19,25	23,39	60,79	1,04
Lithuania	0,50	0,12	0,64	0,41	80,23	4,23
Luxemburg	0,34	0,42	0,16	0,21	29,06	0,63
Malta	0,07	0,07	0,09	0,08	82,30	1,51
Poland	5,13	2,72	6,64	3,36	79,93	1,57
Slovakia	0,80	0,51	0,97	0,60	75,91	1,52
Slovenia	0,39	0,11	0,40	0,36	64,18	4,33
UK	12,92	34,54	9,33	10,43	45,28	0,39
EU27	100,00	100,00	100,00	100,00	59,72	2,16

Source: ECB, Statistical Data Warehouse, ECB (2012)

Table 2 - Impact of Regulation 2560/01- Charges for Credit Transfers 2001/2005

Country	Evolution of charges (1)	Typical Sender charges		Observations
		2002	2005	
Austria	A	€0.00-1.20	€0.00-1.20	10-20 free transfers are typically allowed per month
Belgium	A	€0.00-0.25	€0.00-0.30	No charge for internet-based transfers
Finland	A	€0.00-4.00	€0.00-4.00	No charge for internet-based transfers
France	D	€2.30-3.50	€2.85-3.90	Increase in charges for non-electronic transfers
Germany	A	€0.00-2.00	€0.00-2.00	Service included in basic account package fee
Greece	D	Min €5.58	Min €12.00	Increase in min fee unrelated to Regulation
Ireland	A	€0.00-0.76	€0.00-0.76	Changes require approval by regulator
Italy	D	€0.25-4.00	€2.00-5.00	Average cost for internet-based transfer is €0.90
Luxembourg	B	€ 0,00	€0.00-1.50	6-12 free transfers are typically allowed per month
Netherlands	A	€ 0,00	€ 0,00	Business customers are charged
Portugal	D	€0.00-1.50	€0.00-3.50	Increase in charge for paper-based transfers
Spain	D	€2.52-28.10	€3.18-29.10 (2)	Charge proportional to value of transfers
Denmark	D	€0.25-2.00	€0.25-2.00	Euro transfers incur a higher fee (€5-6)
Sweden	A	€0.00-1.65	€0.00-1.65	Euro transfers incur a slightly higher fee (ca. €0,33)
UK	A	€ 0,00	€ 0,00	Euro transfers incur a much higher fee (€26-36)

Key:

A - No charge before Regulation, no charge after Regulation

C - Charge before Regulation, no charge after Regulation

B - No charge before Regulation, charge after Regulation

D - Charge before Regulation, charge after Regulation

Notes:

(1) - Based on charges most commonly levied

(2) - Average charge for €500 and €10.000 transaction in December 2004

Source : European Commission - Retali Banking Research Ltd, London, Sept. 2005.

Table 3 - Comparison of charges of cross-border payments- 1993- 2012

The evolution of the charges of transferring EUR 100 cross-border, in EUR									
	Study	**Study**	**Study**	**Study**	**Study**	**Study**	**Study**	**Study**	
	1993	**1994**	**1999**	**2001 (1)**	**2001 (1)**	**2003**	**2005**	**2012**	
								on.line	o-t-c
Austria	-	-	10,61	17,4	22,27	11,19	0,6	0,11	0,89
Belgium	23,93	23,06	13,37	11,87	12,84	14,26	0,15	0,5	0,52
Finland	-	-	20,11	14,36	21,26	18,71	2	0	2,7
France	34,79	33,01	16,88	18,06	25,41	22,62	3,4	0,29	3,44
Germany	19,57	26,16	13,78	11,93	14,73	10,56	1	0,01	0,43
Greece	27,23	32,78	-	-	47,33	31,09	12	0,53	11,75
Ireland	23,04	27,13	25,98	25,04	36,08	22,24	0,38	0,11	0,44
Italy	19,79	20,88	18,28	19,74	28,61	16,71	3,5	1,39	3,67
Luxemburg	16,84	15,75	8,91	9,58	9,79	9,89	0,75	0,17	1,2
Netherlands	17,69	18,84	10	11,45	12,11	11,11	0	0	6
Portugal	34,37	26,75	29,68	31,04	28,08	18,12	1,75	0,42	3,26
Spain	21,1	22,04	20,5	20,56	24,65	19,78	4	2,45	2,93
Average	**23,84**	**24,64**	**17,1**	**17,37**	**23,6**	**17,19**	**2,46**	**0,50**	**3,1**

(1) Results of two studies for 2001: the first are based on a sample of 352 and the second on a sample of 1480.

Source: European Commission (2006) Staff Working Paper on the impact of Regulation EC No 2560/2001 on bank charges and national payments; London Economics (2013).

Table 4 – The legal cornerstone of SEPA

	Currencies	*Geographical Area*	*Scope*
Regulation 2560/01 Regualtion 924/2009	Euro and Swedish kronor*, optional for other EU currencies idem	EU 15 EU 12, EEA 3 (for euro and SEK payments) idem	Credit transfers, card payments, ATM withdrawals Direct debits
PSD	All EU currencies	EU 27 Possibly EEA 3 (pending the decision of the EEA Joint Committee)	General purpose – electronic payments
SEPA	Euro	EU 15 EU 12, EEA 3, EFTA 1 (for euro payments)	Credit transfers, direct debits, card payments

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CAN THE EUROPEAN CENTRAL BANK CREATE A EUROPEAN IDENTITY? [1]

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In what ways do central banks construct community, and how may the European Central Bank (ECB) contribute to a supranational European identity? In this paper I seek to answer these two questions by developing a conceptual framework for the ways that central banks construct national identities and community. I use this framework to discuss the possibilities and challenges to the European identity-construction of the ECB. I argue that central banks generally create national identity and outline national communities in four ways: (a) through the practice of designing and circulating banknotes and coins, (b) by conducting national monetary policy that reinforces an impression of popular sovereignty and shared national fate, (c) through the statesman-like authority of the central bank director, and (d) through the headquarters of the banks themselves which operate as commemorative monuments. I then use the ideas to reflect on whether or not the ECB might contribute to the construction of a European identity. I argue that the ECB may contribute to European identity through the circulation of euro banknotes and coins, and that the ECB's anti-inflationary policies may promote European community. However, the identity-cultivating qualities of the ECB are severely challenged by the continuous existence of national central banks that function as strong symbols of national identity within the different member states.

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A community of interest is assuredly a powerful bond between men. Do interests, however, suffice to make a nation? I do not think so. Community of interest brings about trade agreements, but nationality has a sentimental side to it; it is both soul and body at once; a Zollverein is not a patrie.

Ernest Renan[1]

1. Introduction

Questions of national identity and community are by no means trivial, as they have real political implications. Within the EU, for example, national identities continuously pose barriers for further European integration[2]. Even in the age of globalization, nations remain important entities that shape identity. This strong source of identity that is offered by the nation constitutes a potential challenge for political elites who seek to promote supra-national communities. Often these elites are forced to use the principles of the nation in order to go beyond it[3]. Monetary organization constitutes one such principle of the nation than can be used to cultivate national, and potentially supranational, identity. As European Central Bank (ECB) President Jean-Claude Trichet remarked in the January 13, 2009 celebration of the 10th anniversary of the euro, «The creation of the euro will one day be seen as a decisive step on the long path towards an ever closer union among the people of Europe»[4].

This essay explores the potential of the ECB to construct a transnational European community to create a closer union among the people of Europe. For the purpose of this essay, drawing on Benedict Anderson, I understand collective identity as an imagined or perceived sense of collectivity that binds people together in a «deep horizontal comradeship»[5].

The last two decades have seen an increasing interest in the connection between monetary organization, national identity, and community. Many

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[1] RENAN, *What is a nation?*, in OLICK – VINITZKY- SEROUSSI - LEVY (Eds.), *The collective memory reader*, New York, 2011.

[2] CAREY, *Undivided loyalties* in *European Union Politics,* 2002; CHRISTIN – TRECHSEL, *Joining the EU?* in *European Union Politics,* 2002.

[3] SMITH, *National identity*, London, 1991, 171.

[4] TRICHET, *The euro at 10: Achievements and responsibilities*, in *Forbes*, January 13 2009. Retrieved from: *http://www.forbes.com/2009/01/13/trichet-euro-crisis-markets-economy-cx_pm_0113ecbtext.html* on August 10, 2014.

[5] ANDERSON, *Imagined communities: Reflections on the origin and spread of nationalism* (Rev ed.), London, 2006.

scholars have underlined the idea that national currencies potentially construct and buttress national identity[6]. In particular, the introduction of the common European currency in 2000 sparked a range of studies that analyzed the connection between the euro and ideas of national belonging and identity. Many of these studies used quantitative data from euro-referenda and Eurobarometer statistics to analyze the relationship between national identity and attitudes towards the euro[7]. Overall, such studies point to the relationship between euro-skepticism and strong feelings of national pride and identity. Similarly, qualitative analyses have suggested that existing ideas and narratives about the national collective define the framework for understanding a supra-national currency like the euro[8].

While the connection between currencies and national identity is well researched, less work has been done on the relationship between central banks and collective identities. Even though the importance of central banks in modern nation-building has long been acknowledged by scholars such as Giddens[9] and Glasner[10], the connection between central banks and national identity has largely evaded analysis. This is surprising, since early

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[6] GILBERT, *Forging a national currency: Money, state-building and nation-making in Canada*, in GILBERT - HELLEINER (Eds.), *Nation states and money: The past, present and future of national currencies*, London, 1999; HELLEINER, *National currencies and national identities* in *American Behavioral Scientist,* 1998; HELLEINER, *The making of national money: Territorial currencies in historical perspective*, Ithaca, 2003; POINTON, *Money and nationalism,* in Cubit (Ed.), *Imagining nations*, Manchester, 1998.

[7] ANDERSON, *Imagined communities,* see above; BINZERER HOBOLT – LEBLOND, *Is my crown better than your euro?: Exchange rates and public opinion on the European single currency*, in *European Union Politics,* 2009; Carey, *Undivided loyalties*, cit.*;* CHRISTIN – TRECHSEL, *Joining the EU?*, above mentioned; JUPILLE – LEBLANG, *Voting for change: Calculation, community, and euro referendums*, in *International Organization,* 2007; KALTENTHALER – ANDERSON, *Europeans and their money: Explaining public support for the common European currency*, in *European Journal of Political Research,* 2001; MEIER-PESTI–KIRCHLER, *Nationalism and patriotism as determinants of European identity and attitudes towards the euro*, in *The Journal of Socio-Economics,* 2003.

[8] MARCUSSEN, *EMU: A Danish delight and dilemma*, in DYSON (Ed.), *European states and the euro: Europeanization, variation, and convergence*, Oxford, 2002; MARCUSSEN – ZØLNER, *The Danish EMU referendum 2000: Business as usual*, in *Government and Opposition,* 2001; SØRENSEN, *The Danish euro: Constructing a monetary oxymoron in the Danish euro debate*, in *National Identities,* 2014.

[9] GIDDENS, *The nation-state and violence* (Reprint ed.), Cambridge, 1996.

[10] GLASNER, *An evolutionary theory of the state monopoly over money*, in DOWD-TIMBERLAKE (Eds.), *Money and the nation state: The financial revolution, government and the world monetary system*, New Brunswick, 1998.

institutionalists such as Karl Polanyi explicitly dwelled on the apparent relationship between central banks and feelings of national community[11].

Very recently, Tognato suggested that central banks must align themselves with discursive practices that reflect national identity in order to become legitimate and obtain monetary stability[12]. As Tognato argues:

> Whenever independent central banks start to speak the languages that define the collective identities of their own societies, and when they manage to recast their own institutional identity into national identity, their basis for support within society becomes much broader, and it gets easier for them to deliver monetary stability[13,14]

The ambition of this essay is to follow Tognato's idea that central banking and national identity are connected. In contrast to Tognato's analysis, I will not focus on central bank legitimacy but instead develop four proposals for the ways in which central banks may contribute to collective identity. I use these ideas to discuss the possibility that the European Central Bank (ECB) might contribute to the construction of a common European identity. Thus, my aim is to highlight a range of powerful examples demonstrating the connection between central banks and collective identity construction, and to suggest potential theoretical entry points into this particular research field from which future studies might benefit. I propose that central banks must be considered elements of a continuous demarcation of national or supra-national communities 1) through the practice of designing and issuing banknotes, 2) by serving as symbols of the shared economic fate and as guardians of popular sovereignty, 3) through the iconization and heroic reputations of central bankers, and 4) through the physical presence of central bank headquarters that serve as theaters of national memory and economic monuments that are a component of ongoing identity politics.

In the four main sections below, each dealing with different bank/identity connections, I use a range of texts and materials. I turn to existing ideas and theories on the cultural elements of central banking, and I utilize both

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[11] POLANYI, *The great transformation* (1st. paperback ed.), Boston, 1957, 205.

[12] TOGNATO, *Central bank independence. Cultural codes and symbolic performance*, New York - Basingstoke, 2012.

[13] TOGNATO, *Central bank independence*, 9.

[14] For more culturally oriented analyses of central bank practices, see also ABOLAFIA, *Narrative construction as sensemaking: How a central bank thinks Organization Studies,* 2010; HOLMES, *Economy of words. Communicative imperatives in central banks*, Chicago, 2013; ROSENHEK, *Diagnosing and explaining the global financial crisis: Central banks, epistemic authority, and sense making*, in *International Journal of Politics, Culture and Society,* 2013.

scholarly and popular literature on central banks and their governors as well as texts from central bank web pages and newspaper articles. Rather than developing a comprehensive theory on the central bank/identity connection, this essay must be considered a catalogue that combines existing theories on central banks, monetary organization, and nationalism with different types of empirical material to generate four hypotheses that future studies might build upon.

2. Circulating banknotes and coins

Perhaps the most obvious way that central banks contribute to the formation of national identity is through the symbols and motives emblazoned on official banknotes and coins. Although electronic payments have become increasingly common, most people still handle money on a daily basis, and the symbols on banknotes and coins has become a part of the national, ever circulating, symbolic repertoire.

In most countries, central banks exercise monopoly over the issuing of banknotes and have the final say in selecting appropriate symbols and designs. In doing so, they supply and reproduce parts of the state's symbolic repertoire. These symbols circulate unnoticed in our daily transactions and become a part of what Billig has deemed the endemic conditions of nations and a form of «banal nationalism»[15]. Many studies have analyzed the purposeful use of currency iconography to promote national identity and expand state legitimacy[16]. At the heart of these studies lies the assumption that the national symbolism found on currencies *does* something to national identity; currency iconography, to use the words of Eric Helleiner, is able to «cultivate a set of common nationalist beliefs and culture»[17].

This view that the iconography of circulating currencies is a tool to promote European identity was indeed a key element of the design process of

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[15] BILLIG, *Banal nationalism,* London, 1995, 41.

[16] See, e.g., GILBERT, *Ornamenting the facade of hell: Iconographies of 19th-century Canadian paper money* in *Environment and Planning D: Society and Space,* 1998; GILBERT, *Forging a national currency*, above mentioned; HAWKINS, *National symbols and national identity: Currency and constructing cosmopolitans in Tunisia*, in *Identities,* 2010; HELLEINER, *The making of national money*, above mentioned; HYMANS, *Money for mars? The Euro banknotes and European identity*, in FISHMAN - MESSINA (Eds.), *The year of the euro: The cultural, social, and political import of Europe's common currency*, Notre Dame, IA, 2006; WALLACH, *Creating a country through currency and stamps: State symbols and nation-building in British-ruled Palestine*, in *Nations and Nationalism,* 2011.

[17] HELLEINER, *The making of national money*, 100.

the euro. When planning the design for the new euro-notes, the European Commission explicitly sought out motifs motives that would bolster a common European identity[18]. The solution was to emblazon the coins with both national and European symbols. Although the euro coins do in fact feature national symbols alongside European imagery, scholars still point to euro coins as medium of banal nationalism that could work to create European community[19]. The new euro banknotes featured no national symbols but referred to a common European architectural tradition. However, the archetypical bridges and buildings that were ultimately chosen to emblazon the notes referred to no specific country or region. The banknotes were kept deliberately supra-national in an effort to not alienate any non-selected country[20]. As such, the euro banknotes and coins are obvious political tools which can be allied to promote European community.

Even though such a view on currency iconography as an ideological messenger appealed to EU policymakers, it might not be quite so straightforward to use money as a medium to promote specific identities. Recent analyses suggest that we have to reconsider this top-down view on currency symbolism. In a 2004 study, Jacques Hymans analyzed and compared banknote iconography from a range of European countries from the turn of the twentieth century until the present. Hymans concludes that European states have historically incorporated pan-European symbols into their note-iconography in an attempt to capitalize on their already established meanings, and not as an attempt to promote specific nationalist agendas. According to Hymans, European issuing authorities have historically sought to exploit the preexisting meaning of these symbols in an effort to promote legitimacy, both internally and externally[21]. In a similar vein, Kaelberer describes the relationship between a currency's legitimacy and existing ideas of community as one of mutually configuration[22]. The trust in and credibility of a currency depends on the preexisting ideas of community and identities in the area in which it circulates.

[18] BEREZIN, *Great expectations. Reflections on the identity and European monetary union*, in FISHMAN - MESSINA (Eds.), *The year of the euro: The cultural, social, and political import of Europe's common currency*, Notre Dame, IA, 2006; HYMANS, *Money for mars?, a*bove mentioned.

[19] RAENTO – HÄMÄLÄINEN – IKONEN – MIKKONEN, *Striking stories: A political geography of euro coinage*, in *Political Geography,* 2004.

[20] FORNÄS, *Signifying Europe*, Bristol, 2012, 215.

[21] HYMANS, *The changing color of money: European currency iconography and collective identity*, in *European Journal of International Relations,* 2004.

[22] KAELBERER, *The euro and European identity: Symbols, power and the politics of European monetary union*, in *Review of International Studies,* 2004.

In a recent study, Penrose followed up on Hymans' suggestion to argue that central bank practices of printing and circulating banknotes with national symbols may not be a deliberate and explicit form of nationalism[23] Instead, the banal evocation of the nation's symbolic repertoire constitutes a form "statization"[24] that makes both state and nation seem ontologically evident[25]. To put is simply, the mere practice of circulating banknotes reinforces the perception that the state really does exist.

2.1. Euros and European community

What, then, is the potential for euro banknotes and coins to construct European community and identity? Following the ideas above, I suggest that the common European currency has the potential to cultivate European community. While the European symbolism *on* banknotes and coins might promote community because they are diffused into the everyday activities of ordinary Europeans, the euro-designs may not be the most potent means for crafting identity. Instead, the mere "state practice" of designing and circulating money makes the idea of a European community seem ontologically evident and reifies the sense of a European collective. When the ECB engages in the practice of issuing money, it also engages in a statization of the European Union. As such, it reaffirms the state-like structure of the EU and, by such a state practice, strengthens a sense of European community.

As noted by Kaelberer, the nation-state as the sole source of political demos is challenged by the EU-structure, which offers a separate type of democratic and political community than the traditional nation-states.[26] The question of community is not a zero sum game, and people are able to simultaneously identify with different kinds of communities. However, the identity-cultivation that is driven by the existence of a common currency only works in countries that have actually adapted the euro. In countries like England and Denmark, the continued existence of national currencies works to reinforce the respective national communities.

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[23] PENROSE, *Designing the nation. Banknotes, banal nationalism and alternative conceptions of the state*, in *Political Geography,* 2011.

[24] PAINTER, *Prosaic geographies of stateness*, in *Political Geography,* 2006, 155.

[25] PENROSE, *Designing the nation*, 434.

[26] KAELBERER, *The euro and the European demos: Money and community beyond the nation-state*, in *Global Society,* 2010, 503.

3. Shared economic fate and monetary sovereignty

Besides the sense of community and identity that is connected to the circulation and designs of physical money, central banks also bind people together in a shared economic fate. As Helleiner notes, monetary events like interest rate changes or national currency devaluation affect society as a whole[27]. The citizens of a nation with a homogenous territorial currency thus «experience monetary phenomena together».[28] Even though monetary events such as money supply changes or interest rate alterations do not affect individuals or groups in the same way, external monetary shocks are still experienced in a synchronous and collective manner. Such collective experiences potentially contribute to a feeling of belonging to a shared community of fate.

3.1. Sovereignty and economic fate in an EU context

How do these ideas about a shared monetary fate and feelings of sovereignty resonate in the context of the ECB? First, the ECB's focus on price stability across the euro-zone can be seen as a type of monetary policy that has the potential to bind Europeans together in a shared monetary fate. Changes in ECB interest rates and euro exchange rates are indeed experienced *collectively* by the citizens of the different euro-countries. However, the general economic conditions across the different euro-countries are still very different, as crisis-stricken countries like Greece and Spain have been on the verge of bankruptcy, whereas countries like Germany have fared much better. Thus, while some elements of ECB monetary policies might carry the potential to bind Europeans together in a shared monetary fate, there is still a long way to go before the Greeks and the Germans can be said to genuinely share the same monetary experience.[29]

As to the second point about the sense of popular sovereignty that stems from being able to conduct independent monetary policies, the structure and competencies of the ECB might very well work to weaken European community. The euro-countries have effectively yielded their right to develop

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[27] HELLEINER, *National currencies and national identities*, 1420.

[28] HELLEINER, *National currencies and national identities*, 1420.

[29] LYNN, *Bust: Greece, the euro, and the sovereign debt crisis*. Hoboken, 2011. Retrieved from: http://site.ebrary.com/lib/librarytitles/docDetail.action?docID=10446681 on August 26, 2014.

and institute individual monetary policies, as they are now governed by a supra-national institution. This was a key argument made by Danish euro-skeptical parties in the debate leading up to the Danish euro-referendum in 2000. According to such arguments, by standing outside the euro-zone, Danish policymakers would retain the ability to choose between different monetary policies. Even if these decisions ultimately proved to be costly and wrong, they would still be the decisions of *Danish* policymakers, and the Danish electorate would retain the opportunity to reward or punish their elected politicians accordingly. The Danish electorate would have given up that opportunity if the euro had been implemented in Denmark[30].

As such, the potential for the ECB to forge a supra-national European community by creating a sense of a shared economic fate and giving the impression that Europeans are, in fact, controlling national monetary policies, is somewhat questionable. Europeans do not, as exemplified by the present circumstances, share most monetary experiences together. In the case of Greece, the ECB became a symbol of EU supremacy and was framed as an organization that impeded on Greek sovereignty. However, implementation of the euro not only leads to feelings of lost sovereignty and influence. After 2000, when central banks within the euro-zone struggled to redefine themselves, central bankers insisted that they still played a role in sustaining national sovereignty. In a 2006 interview, an official from the Central Bank of the Netherlands argued that, «Before the [European Monetary Union] we were just following the policies made in Germany; after we joined the [European Central Bank] we once again became a part of the group of people that were setting monetary policy»[31]. Of course, the view expressed here is the view of a central banker. Whether Europeans generally share the same kind of optimism and consider the euro an increased opportunity to conduct monetary policies, remains questionable.

4. Central bank governors: heroes and superstar technocrats

A third way that central banks create collective identities is through the perceptions and representations of the central bank governors. Even though it remains contested whether the persona of the central bank governor indeed

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[30] SØRENSEN, *The Danish euro*, above mentioned.

[31] MAES - VERDUN, *National banks of Belgium and the Netherlands: Happy with the euro*, in DYSON - MARCUSSEN (Eds.), *Central banks in the age of the euro: Europeanization, convergence, and power,* Oxford, 2009, 109.

affects actual monetary policies[32], central bank governors have the potential to function as national heroes that embody their national communities. According to historian Geoffrey Cubitt, a hero must be understood as "any man or woman whose existence, whether in his or her own lifetime, or later, is endowed by others, not just with a high degree of fame and honour, but with a special allocation of imputed meaning and symbolic significance – that not only raises them above others in public esteem but make them the object of some kind of collective emotional investment"[33]. As Anthony D. Smith has shown, the interpretation and reinterpretation of a cadre of national heroes constitutes a key element of the symbolic construction of national communities. As Smith notes, «While definitions of grandeur and glory vary, every nationalism requires a touchstone of virtue and heroism, to guide and give meaning to the tasks of regeneration»[34]. Thus, heroes provide the nation with concrete human form as the national myth becomes incarnated in the virtues of this heroic individual[35].

While some research has been conducted on the importance of kings and presidents as national symbols[36], less work has investigated the notion of central bankers as national heroes, ones who are safe guarders of national sovereignty and national, monetary heroes. Stuckey, for instance, argues that the U.S president «has become the nation's chief storyteller, its interpreter-in-chief»[37]. According to Stuckey, the stories that presidents tell demarcate the American nation and the national community.

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[32] MEHRLING – MOSS – PIXLEY – TAVLAS, *What if the leader of the central bank told hilarious jokes and did card tricks? A panel of experts* in *American Journal of Economics & Sociology,* 2007; SØRENSEN, *Superstar technocrats: The celebrity central banker*, in *Celebrity Studies,* 2014.

[33] CUBITT, *Introduction: Heroic reputations and exemplary lives* in CUBITT - WARREN (Eds.), *Heroic reputations and exemplary lives*, Manchester, 2001.

[34] SMITH, *Myths and memories of the nation*, Oxford, 1999, 64-5.

[35] HUTCHINS, *Heroes and the renegotiation of national identity in American history textbooks: Representations of George Washington and Abraham Lincoln, 1982–2003*, in *Nations and Nationalism,* 2011, 650.

[36] CANNADINE, *The context, performance and meaning of ritual: The British monarchy and the 'invention of tradition', c. 1820-1977,* in HOBSBAWM - RANGER (Eds.), *The invention of tradition*, New York, 2008; HUTCHINS, *Heroes and the renegotiation of national identity*, above mentioned; SCHWARTZ – SCHUMAN, *History, commemoration, and belief: Abraham Lincoln in American memory, 1945-2001*, in *American Sociological Review,* 2005; STUCKEY, *The president as interpreter-in-chief*, Chatham, 1991; STUCKEY, *Defining Americans: The presidency and national identity,* Kansas, 2004; TYRRELL – WARD, '*God bless her little majesty': the popularising of monarchy in the 1840s*, in *National Identities,* 2000.

[37] STUCKEY, *The president as interpreter-in-chief*, 1.

In the same vein, I propose that central bankers potentially constitute heroic, quasi-religious symbols of national character that both render meaning to and draw meaning from the prevailing conceptualization of the national community. In a 2004 article, Tognato even spoke of central banking as a form of «secular religion», and showed how public representations of the German Bundesbank and its chairman have historically been permeated with religious references[38]. In a similar vein, Johnson dubbed central bankers «the priests of prosperity», underscoring the religious aura and connotation of central bankers[39].

Let me put forth a couple of examples. In his salutatory work on Alan Greenspan, renowned journalist Bob Woodward anointed the long standing U.S. Federal Reserve (Fed) chairman as «the symbol of American economic preeminence»[40]. Although Greenspan's bibliographic legacy was later tainted by the financial turmoil of 2008 and subsequent recession[41], for many years Greenspan served as a monetary father figure who incarnated the promise of American economic prosperity.

Similarly, bibliographers of Greenspan's predecessor, Paul Volcker, depicted the cigar-smoking Fed-chairman as a «financial legend».[42] In the words of Volcker's biographer William Silber, he was indeed «more than a central banker»; he was the «hero» who captained «the epic battle against the Great Inflation in the 1970s»[43]. In the eye of the public, Volcker's battle with inflation saved the country from economic ruin and he thus «became a hero to many of his fellow countrymen»[44]. Volcker eventually attained the aura of central banking super star when he was portrayed on the cover of Time Magazine in 1982. Present day chairman Ben Bernanke (the 2009 Time Person of the Year) was depicted on the cover of The Atlantic in March 2012. Here, Bernanke was described as the «hero» who, during the 2008 economic

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38 TOGNATO, *In the name of money: Central banking as a secular religion.* Manuel Ancizar lecture Universidad Nacional, Bogotá, October 30, 2004, unpublished.

39 JOHNSON, *Priests of prosperity: The transnational central banking community and post-communist transformation*. Paper presented at the European Union Studies Association biannual meeting, April 2007, unpublished.

40 WOODWARD, *Maestro: Greenspan's Fed and the American boom*, New York, 2000.

41 BATRA, *Greenspan's fraud,* New York, 2005; FLECKENSTEIN – GREENSPAN – SHEEHAN, *Greenspan's bubbles: The age of ignorance at the Federal Reserve*, New York, 2008.

42 TREASTER, *Paul Volcker: The making of a financial legend*, Hoboken, 2004, cover page.

43 SILBER, *Volcker: The triumph of persistence,* New York, 2012, 1-2.

44 SILBER, *Volcker,* 1-2. See also SØRENSEN, *Superstar technocrats: The celebrity central banker,* above mentioned, for an elaborated argument on central bankers as heroes and villains.

crises, rescued America and «navigated masterfully through the most trying of times»[45].

Obviously, prominent central bankers have not always encouraged this positive alliance to the nation. Central bankers who are perceived as villains might inspire quite the opposite reaction[46]. The point is simply that central bankers have the potential to possess the heroic qualities that could make them national symbols who contribute to national identity formation.

4.1. The ECB president as a monetary hero?

Will the persona of the ECB resident have the ability to act as a European monetary hero and construct a European community? At first glance, one might think that Mario Draghi, for example, held such heroic potential. For example, on a 2013 cover of Time Magazine, Draghi was described as the man who would fight to save not only the euro, but also the dream of a united Europe[47]. In a similar fashion, Jean-Claude Trichet has been described as «the perfect mister euro» who was well aware that monetary matters is closely related to issues of national identity[48].

However, although the ECB president might hold heroic potential to forge European community, as with most central bankers, Draghi and Trichet also possess a potent villainous potential. Both Greek and Spanish protesters have regularly used both pictures and full-sized (ignited) puppets of both Trichet and Draghi while demonstrating against what they perceived to be austerity measures imposed by the ECB. As such, the perception and heroic potential of the ECB president is inherently bound up in general economic and monetary circumstances. When things go right, they may be worshiped, but when economic crisis hit, they are the first to be blamed. This point parallels Hansen's recent work that shows how bankers, and financiers in general, have

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[45] LOWENSTEIN, *The villain,* in *The Atlantic,* April 2012. Retrieved from http://www.theatlantic.com/magazine/archive/2012/04/the-villain/308901/ on November 13, 2013.

[46] Indeed, when Paul Volcker launched his anti-inflationary campaign in the early 1980s and raised interest rates in the wake of the recession, he very quickly became a loathed figure, was designated an "enemy of the state", and was accused of conducting anti-American policies.

[47] MAYER – SCHUMAN, *Mario Draghi: The man who would save Europe*, in *Time Magazine*, January 17 2013. Retrieved from http://business.time.com/2013/01/17/mario-draghi-the-man-who-would-save-europe/ on November 20, 2013.

[48] LYNN, *Bust,* above mentioned.

historically been exalted as heroes or branded as villains, depending on the contextual interpretations of their deeds[49].

Another point that threatens the ECB president's heroic reputation is the fact that the president of the ECB is competing with the central bank governors of the different member states. As the countries of the euro-zone have retained their own central banks and central bank governors, the ECB president is not the only figure who incarnates the monetary fate of the various member states. Even though the ECB president could be a symbol of European community, the mere existence of national central banks across Europe dilutes the symbolic potency of the ECB president. National central bankers indeed have the potential to strengthen the national identity in different euro-countries. Even though it is possible for individuals to simultaneously possess a range of different identities (for instance, to be both German and European at the same time), the competing presence of national and supranational central banks most likely weakens the community-cultivating potential of the ECB president.

5. Central bank headquarters – the hearts of monetary policy

Finally, central bank headquarters constitute a material manifestation of the otherwise abstract concept of monetary policy. To paraphrase Leyshon and Thrift, the physical spatiality of financial centers are «what make the non-place electronic realm conceivable»[50]. Even though, as French et al. have argued,[51] conceptualizing the nation state as the sole container of economic activity fails to adequately describe the networks of international finance, the headquarters of national central banks still constitute the most visible symbols of an enforced monetary authority, which since the beginning of the 20th century has been considered an indispensable element of national economic sovereignty[52].

I suggest that central bank headquarters can be considered monetary monuments and sites of economic commemoration. As Boyer argues, the

[49] HANSEN, *Making sense of financial crisis and scandal: A Danish bank failure in the first era of finance capitalism*, in *Enterprise and Society,* 2012.

[50] LEYSHON – THRIFT, *Money/space: geographies of monetary transformation*, New York, 1997, 307.

[51] FRENCH – LEYSHON – WAINWRIGHT, *Financializing space, spacing financialization*, in *Progress in Human Geography,* 2011, 808.

[52] LEYSHON – THRIFT, *Liberalisation and consolidation: The single European market and the remaking of European financial capital*, in *Environment and Planning A,* 1992.

ornate buildings erected by state elites function as theaters of memory that offer an opportunity for the ritualistic enacting of state practices.[53] The sense of sameness over time that exists at the core of any individual or group identity is sustained by the process of remembering[54]. But collective memory does not happen by itself. It needs to be stimulated, reproduced, and spatially situated. Public memory, understood as the process that forms prevailing cultural understandings of "nation" or "people", is both spatial and social in nature[55].

Arguably, the physical headquarters of national central banks constitute only a small part of the large pool of potential symbols that can be mobilized to demarcate a national community. However, the conspicuous buildings of central banks around the world differ from other types of monuments, including royal castles or grand boulevards, with respect to the functions they perform. They are the material manifestations of the nation's shared economic fate and they often epitomize power, wealth, and stability. Through the promise to either speed up or slow down the wheels of the printing press, central bankers are perceived to control the nation's faith from their corner offices.

In his 1987 book *Secrets of the Temple*, William Grieder contributed to the mystification of the Fed and its governing body by arguing that, «The governors of the Federal Reserve decided the largest of questions of the political economy, including who shall prosper and who shall fail, yet their role remained opaque and mysterious»[56]. Although the Fed's decision making process and its governors, especially in the Bernanke-run Fed, might be less unintelligible and occult than Greider imagined, the Federal Reserve Headquarters on Constitution Avenue in Washington DC does indeed look like a temple. Its monumental scale, marble columns, and classical ornamentation all serve to spark the conception that something esoteric yet profoundly important occurs inside its walls.

This is why central bank buildings stand as monuments of monetary clout and potency. For example, on the homepage of the Swedish central bank *Riksbanken*, visitors are informed of the design considerations of headquarter-architect Peter Celsing. «If you think the building seems impregnable, that was exactly Celsing's intention. Sveriges Riksbank is supposed to look like

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[53] BOYER, *The city of collective memory: Its historical imagery and architectural entertainments*. Cambridge, MA, 1994, 1-29.

[54] GILLIS, *Commemorations: The politics of national identity*. Princeton, 1994, 3.

[55] FOREST - JOHNSON – TILL, *Post-totalitarian national identity: Public memory in Germany and Russia*, in *Social & Cultural Geography,* 2004, 358.

[56] GREIDER, *Secrets of the temple: How the Federal Reserve runs the country*, New York, 1987, 12.

the strongbox that it is. A building built to last»[57]. Here, Riksbanken's building is explicitly articulated as an everlasting fortification from which Swedish monetary policy emanates.

In some cases, central banks endeavor in even more overt identity policies that go beyond the power of monumental headquarters. The central banks of England, Germany, Japan, Canada, Finland, and Belgium (amongst others), have established permanent currency or bank museums that are directly connected to and operated by the bank. According to the Currency Museum of the Bank of Canada, the purpose of its exhibitions is to «interpret Canada's monetary and economic heritage, increase public awareness of the Bank of Canada, and foster confidence in bank notes and the Canadian financial system»[58]. The Bank of England and its museum have design a designated "kid's corner" where families and schools are able to «discover some of the treasures in our collections, and some surprising facts about the Bank and its history!»[59]. These central bank museums are not neutral disseminators of objective historical fact. Like any other museum or other type of organized cultural heritage, these institutions are inherently political. Museums play an important part in the continuous process of commemoration and are crucial to the politics of national identity. Through the display of national cultural heritage, they act as a force in forging self-consciousness[60].

National identity and the process of collective remembering or commemoration are sustained by cultural artifacts (i.e., what is sometimes called cultural heritage). In his seminal analysis of cultural politics and nationalism in Quebec, the American anthropologist Richard Handler describes this «fetishism of material culture». According to Handler, the very existence of material culture such as artifacts, monuments, and buildings often justifies and legitimizes the existence of ethnic communities. In order to claim a certain national identity, the display of cultural relics is often used in a tautological fashion to demonstrate that one actually *has* a culture.

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[57] Sveriges RIKSBANK, *The architecture.* Retrieved from http://www.riksbank.se/en/The-Riksbank/The-building/The-architecture/ on May 22, 2013. The website text is in both Swedish and English. The original Swedish word choice further underlines the supposedly timeless and immutable qualities of Swedish monetary authority. Here, the headquarters are described as "*Ett hus byggt för evigheten,*" which can be translated as "a building erected for all eternity".

[58] BANK OF CANADA, *About the museum.* Retrieved April 4, 2013, from http://www.currencymuseum.ca/about-museum/.

[59] BANK OF ENGLAND, *Bank of England museum.* Retrieved April 4, 2013, from http://www.bankofengland.co.uk/education/Pages/museum kids/default.aspx.

[60] KAPLAN, *Museums and the making of "ourselves": The role of objects in national identity*, London, 2004, 1.

Communities thus claim and cultivate national identity by pointing to their tangible remnants of material culture[61]. Similarly, Johnson points to monuments as important centers around which expressions of local and national identity can be articulated[62].

Handler and Johnson's points are particularly interesting if we look at the commemorative politics of the Central Bank of Switzerland. *Die Schweizerische Nationalbank* not only celebrated its 100th anniversary publishing a more than 800 pages of commemorative publication with contributions from renowned international scholars of financial history such as Michael Bordo and Harold James, but the bank also launched a publication, more than 100 pages in length, dedicated exclusively to its Bern headquarters that were founded in 1907. The commemorative power and symbolic importance of this building was highlighted in the preface written by the board of governors:

> A building makes an institution visible and gives it is own distinct expression. The construction of a new building is therefore a challenging undertaking. It needs not only to practical, aesthetic and integrated in its surroundings environment, it must also possess a highly symbolic force. Ideally, the building is a symbol of the institution it houses[63].

Under the headline 'The Swiss National Bank: A Monument'[64], the authors set the scene by noting that it is the Swiss Central Bank and not the Swiss Parliament that occupies the prestigious address *Bundesplatz Nummer*

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[61] HANDLER, *On having a culture. Nationalism and the preservation of Quebec's patrimoine*, in STOCKING (Ed.), *Objects and others: Essays on museums and material culture*, Madison, 1985.

[62] JOHNSON, *Cast in stone: Monuments, geography, and nationalism*, in *Environment and Planning D: Society and Space,* 1995.

[63] HILDEBRAND – JORDAN – DANTHINE, *Vorwort des Direktoriums der schweizerischen Nationalbank* in BAUMANN – HALBEISEN – RUOSS (Eds.), *Die schweizerische Nationalbank in Bern eine illustrierte Chronik,* Zürich, 2012. Authors' translation of the German into English: [*Ein Gebäude macht eine Institution sichtbar und gibt ihr das Gepräge. Der Bau eines neuen Gebäues ist deshalb ein anspruchsvolles Unterfangen. Es muss nicht nur zweckmässig sein, ästhetischen Ansprüchen genügen und sich gut in die Umgebung einfügen; es muss auch von hoher Symbolkraft sein. Im Idealfall wird das Gebäude zum Sinnbild für diejenige Institution, die es beherbergt.]*

[64] The Swiss German word *baudenkmal* encapsulates the perceived commemorative qualities of the building.

1. This point, the authors argue, will not be lost on an audience with just a little knowledge about Switzerland as a financial center[65].

5.1. Frankfurt as Europe's monetary heart?

Does the ECB hold the same promise and potential monetary monument and *baudenkmal* (a commemorative building) that reflects and reinforces European identity? Until recently, the ECB resided in the looming Eurotower building in Frankfurt. Adjacent to the main entrance, a euro-symbol that was more than 20 feet tall welcomed visitors and marked the building as the absolute epicenter of the European monetary union and its central bank. The symbolic qualities of the European Central Bank headquarters became very overt when construction of a new ECB premise began in 2010. In fact, the building was explicitly framed as a symbol of European identity. According to the bank's website, «The ECB's new premises will not only create a single base for its operational activities, but also stand as a visible symbol of the ECB's identity»[66].

In a speech at the ground stone laying ceremony in Frankfurt in May 2010, Lord Mayor Petra Roth articulated the spatiality of monetary policy when she addressed EBC President Jean-Claude Trichet. «The European Central Bank», Roth declared, «is the heart of hearts of this financial centre and within the last few weeks it has perhaps been the most important European institution of all. Brussels is the decision making centre of the European Union and Frankfurt is the nucleus from which Europe's financial policy emanates»[67]. The heart analogy outlines a metaphorical European physiology in which Frankfurt, and the ECB building in particular, becomes the absolute epicenter of European monetary authority. In September 2012, at the topping out ceremony of the new ECB premises, ECB executive board member Jörg Asmussen once again underlined the symbolic qualities of the new building, expressing a «hope that our new premises will be viewed by the people of

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[65] BAUMANN – HALBEISEN – RUOSS, *Die schweizerische Nationalbank in Bern eine illustrierte Chronik,* Zürich, 14.

[66] ECB, *A symbol of identity.*, retrieved from http://www.ecb.europa.eu/ecb/premises/intro/vision/html/index.en.html. on May 13, 2013

[67] ROTH, *Grundsteinlegung Europäische Zentralbank am 19. Mai 2010 um 17 Uhr. Ansprache Oberbürgermeisterin Petra Roth,* 2010. Retrieved from: http://www.ecb.int/ecb/premises/pdf/20100519_speech_ob_roth.pdf?e22b95869b0a35bf58caa7959d51a43d on May 16, 2013.

Frankfurt, and beyond, as an enrichment of Frankfurt's skyline and the landscape of Europe»[68].

Whether the ECB building will actually work as a commemorative monument of Europeanness and enrich "the landscape of Europe" remains to be seen. At least one obstacle challenges the potency of the ECB premises as a commemorative site; the continued existence of central bank buildings across the different euro-countries reinforces the image of national monetary sovereignty. These central bank headquarters are often located at conspicuous and prominent addresses adjacent to parliaments and other official institutions. Each day thousands of individuals pass these buildings, and when they do so they are banally confirmed of the potency of their state institutions, becoming situated in a national landscape rather than a European landscape on a regular basis.

6. Conclusion

In this essay, I have used a range of different materials in a combination with various theoretical concepts to suggest four ways in which central banks might reinforce collective identities. First, I suggest that central banks reify the sense of national or supranational community by designing and circulating banknotes. However, in contrast to most existing research on currency iconography, I downplay the idea of top-down identity cultivation through currency iconography. Instead, by drawing on the work of Penrose, I argue that we must instead consider the design and circulation of the European currency as a form of "state practice" that makes a European state and a European community seem ontologically evident. This practice of statization through currency production is one potential way that the ECB could contribute to a European community and identity.

Secondly, following Helleiner, I argue that central banks contribute to community and identity by binding people together in a shared monetary fate and by giving impression of popular sovereignty. Although the stability culture of the ECB could potentially bind Europeans together in a shared monetary fate, the general economic conditions across the euro-zone are still very uneven. Other economic circumstances such as unemployment and the development of a national balance of payment might prove stronger sources

[68] ASMUSSEN, *New ECB premises topping out ceremony. welcome address by Jörg Asmussen, member of the executive board of the ECB, Frankfurt am main, 20 September 2012.*, retrieved August 22, 2014, from http://www.ecb.europa.eu/press/key/date/2012/html/sp120920_1.en.html.

of a collective sense of shared economic fate than one that stems from the anti-inflationary policies of the ECB.

Thirdly, I suggest that central bank governors contribute to national identity when they are perceived as national heroes, safe-guarders of the economy, and as symbols of collective prosperity. I argue that is unlikely for the ECB president to develop into such a pan-European hero and icon that inspire feelings of Europeaness and forges European community. On the contrary, in southern European euro-countries, the ECB president has sometimes been framed as a villainous character that inspired nationalist, and not European, feelings. Also, the continued existence of national central bankers across the euro-zone potentially mitigates the strength of the ECB president as a symbol of Europeaness.

Finally, I argue that central bank buildings and headquarters constitute theaters of national memory and work as monetary monuments able to sustain a collective memory of the nation and contribute to national identity. Although European politicians and central bankers explicitly consider the ECB premises to be a European monument, the presence of various central bank headquarters across the euro-countries undermines the potency of the ECB premises as an integrating symbol of European *baundenkmal.*

The four suggestions developed in this essay might very well prove to be overlapping, and I claim no clear cut boundary between the different phenomena. Instead, my ambition has been to propose a conceptual framework for the role of central banks in forging community. By concisely considering these ideas within the context of the European central bank, I have pointed to a range of opportunities, but also to considerable challenges, that face the ECB in the task of cultivating European identity.

WHEN DIVERSITY AND CULTURAL IDENTITY MEET A COMMON PAYMENT SYSTEM:THE CHALLENGES FACED IN INTEGRATING A SINGLE PAYMENT SYSTEM WITHIN THE EUROPEAN UNION

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Nowadays we are facing an era where it can be easily admitted that there's no state found on the international scene with a legitimate monopoly over the use of force and the capacity of authoritative rule enforcement. European Union is one of the most successful international cooperation and by far the most significant and far-reaching attempts at regionalism. Being an organization that brings together a number of several countries, the challenge of this model of regionalism, consists in dealing with different cultures, languages, law systems and constitutions and nevertheless financial systems. Is it possible, that in an already intricate organization, characterized as dissimilar and which often seems to develop in an ad hoc manner, to successfully overcome such tough national barriers? The primacy of the European Union's law represents one of the fundamental principles of the Union law and has been, since the beginning, a proof of loyalty and devotion for building unity among the European countries but dealing with a common payment system may prove much more difficult to handle.

This paper aims to analyze the current state of the implementation process of integrating a single payment system within the EU, resulting in an analysis of the current state dealing with diversity and strong cultural identities. Could the EU successfully accommodate such a concept taking into account the challenges resulting from the mere essence of a pluralistic community?

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1. European culture and identity: Concepts and implications
2. Implementing a common payment system

1. European culture and identity: Concepts and implications

European culture is not a precise concept that we can surely define, since identity can be characterised as an accumulation of several different values. Although, EU is an ongoing changing political unit that is encouraging its integration more and more, it represents also a platform characterized by cultural diversity. Consequently, European identity has become central to the politics of European constitution and to the never-ending struggle to solve its legitimacy problem[1].

Over the years, there have been distinguished multiple cultural efforts, that were intended not only to advocate a cultural unity but also to develop a new kind of European thinking, one capable of mobilising Europe's 505 million citizens towards a new conception of thinking themselves as "Europeans"[2]. Among the most important aspects of people's culture and identity are language and history, the principle two areas which most divide EU Member States. In most current debates regarding European integration, the notion of culture still remains an abstract term, usually used to embody how European integration brings more than economic benefits. Even though culture is said to be so fundamentally important, the European Union has never clearly shaped its cultural policy. Culture in general and cultural policies were not considered priorities during the first period of European integration and were discussed only in the later phases[3].

Even though most member states still reject the idea of formulating "common cultural policy" and insist on respecting the well-known principle of "subsidiarity", there has also been an unanimity in favour of implementing a certain degree of cooperation in the cultural field, this being a result of the acceptance the fact that many issues require a coordination at a European level. While debates still focus mainly on the need for a European cultural policy, at the same time it's possible to affirm that, in fact European cultural policy already exists, even if it is not yet clearly defined[4].

Provisions from various common policies have an impact on culture, referring to both policies that refer specifically to culture and those that have

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[1] HALL, *The Question of Cultural Identity in Modernity: An Introduction To Modern Societies*, Blackwell Publishing, 2006.

[2] AHTONE et al., *Europe 2020: delivering well-being for future Europeans*; European Policy Center, 2010.

[3] MCNAMARA, *The Eurocrises and the uncertain Future of European Integration*, CFR's International Institutions, 2010.

[4] NICOLAIDIS, *Whose Europe? National Models and the Constitution of the European Union,* European Studies at Oxford Series, Oxford University Press, 2003.

a more indirect impact on culture. In a report issued by the European Parliament, Ruffolo disputed that economic prosperity alone, either the single market and single currency, could not have mobilized member states and their citizens for European integration if there had not been a clear political goal behind it[5]. This kind of political union, if it wants to success in becoming a real union, has to empower member states to also gather some common cultural beliefs beside simple economic interests. Ruffolo also stated within the report, that the conception of European cultural policy would rather shape a model that can afford all member states equivalent opportunities for the promotion of cultural diversity, achieving in this way the goal of what he termed "*unity in diversity*".

In the current context, some may say that EU should rather focus on political issues and its resultants rather than economical or cultural one. To start off, it is necessary to analyze the democratic legitimacy of the EU within its own structure, since democracy is a main value for the EU as understood from its activities and proceedings[6].Currently, the EU has 28 member states and a population of approximately 500 million people. This being said, nowadays the EU is criticized for the lack of democratic architecture although it keeps on expanding its authority, a clear proof being the accession of Croatia, in 2013. Nation-states decision-making aptitude and policy-making capacities were so much shifted from the national to the transnational level. The notion of transnational and supranational democracy have gained greater power[7].

At the same time, the world's system of international relations has changed significantly. Conventionally, academic literature on the issue of democratic deficiency in EU is based on two opposing point of views[8]. The prevalence argument is that there is democratic deficit in the EU whilst the minority argument rejects this perspective. The majority argument draws on the two dimensions of the EU. The prime argument claims that the EU's institutional design and configuration is not charaterised as a democratic one. It's clear that one cannot evaluate the concept of legitimacy within the EU entirely on the ground of these structures, since the EU is neither a federal state nor an international government. In some cases, for example if the EU

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[5] Ruffolo Report on Cultural Cooperation in Europe, 16 July 2001.

[6] BÖRZEL – RISSE, *Diffusing (Inter-) Regionalism: The EU as a Model of Regional Integration*, KFG Working Paper Series, Free University Berlin, 2009.

[7] MORAVCSIK, *Europe, the Second Superpower*, in *Journal of Contemporary World Affairs*, 2010.

[8] SCHMITER, *The future of democracy in Europe.Trends. Analyses and Reforms,* Central European political science review, 2006.

would be evaluated in terms of legality, it could raise several questions regarding the basis of legitimacy in the EU. Overall, it would be questioned from where the EU takes its legitimacy, more exactly if it has resulted from people or institutions. The EU is currently involved in the consolidation and establishment of democracy within the member states and the third party, represented by states that signed agreements with the EU agreements[9]. The support given to the election activities among several countries through electing monitoring represent a visible aspect of this activity of consolidation and establishment of democracy. The EU developed several mechanism and instruments to grow and to inject the concept of democracy in several countries. The EU has been consolidating partnerships and has been taking part of the process of persuasiveness and confidence-adjustment both nationally and locally, so that it can brace democracy among these countries[10].

2. Implementing a common payment system

A memorable moment in terms of payment system was the introduction of euro currency in the EU area, starting with January 1st 2002. Originally, payment and securities settlement systems in the EU were built with the aim of meeting domestic requirements and they weren't quite suited to the needs of a single currency area. Facing this background and all this challenges, the EU has undergone fast changes found both in the run-up to and following the introduction of the euro. Introducing a single currency has also accelerated efforts to consolidate and harmonise payment and securities settlement systems[11].

In order to foster and to harmonise payment system general applicable at EU level, cultural identity and diversity plays a big part along this process. Dealing with cultural identity is closely related with cultural policy, while we can observe that one common cultural policy applicable for the whole European region does not exist and we only have a set of common principles

[9] JONES, *Beyond blocs: The West, Rising Powers and Interest-based International Cooperation,* Policy Analysis Brief, Stanley Foundation, 2011.

[10] HURRELL, *On Global Order: Power, Values and the Constitution of the International Society*, Oxford University Press, 2007.

[11] JETIN-PLIHON, *Financial Integration and Common Payment Systems: Eco-nomic and Financial Regional Integration: Lessons from the East Asian and European experiences*, Paris-Nord University 2005.

that belongs to such a cultural policy[12]. Is it possible to come to an agreement over how it should look further a common payment system or a common style of policy decision, taking into consideration cultural identity? Although the EU has launched and achieved some significant payment policies and results, it is still largely characterised by fragmented payment systems due to several challenges that were faced since it very beginning.

Still to this day financial integration represents one of the most important targets of the EU, having the goal of implementing common infrastructures and payment systems, being well know that it represents one of the condition that guarantees an efficient allocation of financial flows among European countries. A key role in the functioning of the economy is to have an efficient and robust payment system[13], that can ensure uniform distribution of liquidity and that can contribute to financial stability[14]. In order to ensure and foster a successful integrated payment system and to admit to a process of europeanization of the payment system, other factors such as the diversity and cultural identity, should be taken into consideration and tackled accordingly. The correlation between cultural identity of European countries and the process of integrating a common payment system, a successful one, is indubitable and should represent an important pawn in decision-making.

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[12] KOKOLA, *The payment system: payments, securities and derivatives and the role of the eurosystem*, European Central Bank, 2010.

[13] JOHANSSON, *Looking to 2060: long-term global growth prospects',* Economic Policy Paper 3, 2012.

[14] EUROPEAN COMMISSION, *European Economic Forecast,* European Economy *2,* 2014.

A SHARIA-COMPLIANT PAYMENT SYSTEM WITHIN THE WESTERN WORLD

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Although money is still the prevailing payment system, as a matter of fact, the whole world does not share the same idea of money.
In particular, under Islamic law, money is regarded as a mere means of exchange, devoid of any value in itself, as opposed to the Western legal tradition which considers it a store of value.
Being Muslims a growing share of the European multicultural population, the article focuses on the Islamic concept of money and the specific payment systems accepted under Shari'a law.
The analysis centers on both traditional instruments of credit (e.g. hawala) and the tools implemented by the Islamic Banking and Finance Industry, taking into account also the relevant standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and briefly pausing on one of the distinctive traits of Islamic finance.
Notwithstanding the well-observable differences that exist between the tenets of Islamic Law and those belonging to the Western legal tradition, comparative law methodology may actually demonstrate that it possible to reconcile these two positions on more practical level, namely on the basis of their operational rules which are not so diverse.

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1. The Islamic Concept of Money
2. The *Riba* Prohibition
3. Basic Rules of Currency Exchange and Paper Money
3.1 The Legitimacy of Forward Currency Exchanges
3.2 Islamic Tools for Currency Exchange

[1] The Author first thought of gratitude goes to the Department of Business and Law of the University of Siena and, in general, to the project coordinators; especially, he tributes a heartfelt thanks to Prof. Gian Maria Piccinelli, Director of the Department of Political Science of the Second University of Naples for his revision of this manuscript, and to Gabriele Crespi Reghizzi for his constant support. Lastly, he would like to thank the colleague of the Second University of Naples, Gennaro Rotondo, for having encouraged him to take part in this valuable project. Every mistake or inaccuracy remains the exclusive responsibility of the author.

3.2.2. Major Shortcomings
4. Instruments of Credit under Islamic Law: *Hawala* and *Suftaja*
4.1. *Hawala*
4.2. *Suftaja*
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1.The Islamic Concept of Money

Although the current Islamic and European legal and financial systems appear to be poles apart, in former times they used to share certain fundamental tenets[2].

Islam is currently the only major religion still prohibiting usury, however in the past Hinduism[3], Judaism and Christianity[4] have all opposed said practice[5].

Striking similarities actually exist among all Abrahamic religions on economic matters and these conceptualizations have influenced the regulation of business transactions over time, or, at least as regards Christians, until the Church preserved both the spiritual and religious power.

In particular, one of the main analogies between Islamic and Christian thinking concerns the concept of money.

Addressing the issue of the notion of money and its evolution throughout centuries of history requires however a short digression pertaining to the concrete origins of such means of payment[6].

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[2] As a matter of fact, the condemnation of interest was shared by both Judaism and Christianity. In particular, the Christian Church, by drawing on the Holy Bible's passages, used to strongly condemn taking and charging of interest, and termed such practice as *usura*. See VISSER, *Islamic Finance Principles and Practice*, Northampton, MA, 2009, 39.

[3] The accrual of interest in Hinduism was prohibited by the rule of *Damdupat*. See DAVID - JAUFFRET-SPINOSI, *I grandi sistemi giuridici contemporanei*, Padua, 2004, 427.

[4] Severe restrictions upon usurious practices were in force for over 1400 years. LEVIS, *Comparing Islamic And Christian Attitudes To Usury*, in LEVIS & HASSAN, *Handbook Of Islamic Banking*, 2001, 64.

[5] LEWIS - ALGAOUD, *Islamic Banking*, Cheltenham: London, 2001, 185.

[6] As it is well-known, the economy during the prehistoric era was based on barter, that is the exchange of commodities. However, such an economic system was highly problematic, mainly due to practical difficulties in the circulation, exchange and storage of perishable commodities, coupled with the lack of a largely recognized method of payment and the impossibility to objectively benchmark the value of the goods exchanged. In light of these deficiencies, barter was deemed unsuitable for the growing requirements of evolving societies and economies. As early civilizations acknowledged the need for a different economic pattern, they developed a first notion of money: a tool that could have been employed as a commodity with an instrumental value, which was made up of a durable good which had to be recognized by both community members and trading partners as a means to purchase goods. The first instruments which were used to that end were objects normally available in one's surroundings, such as shells, salt, silk, certain stones like obsidian, metals and, at times, even livestock. Money - in its modern form of small disks made up of precious metal, characterized by uniform weight and dimension, and a conventional value - started to be coined only at a later stage. The practice of "coinage" consisted in «the packaging of metal commodities into tradable units» (DOHERTY, *Bitcoin and Bankruptcy - Understanding the Newest Potential Commodity*, in *ABIJ*, 2014, vol.33 (7), 38). Historically, the origins of coinage date back to the 6th century before Christ and said practice

As trading activities increased over time throughout the entire area of the Arab Peninsula, barter started to be replaced with money. Since then, the Islamic legal community engaged in defining the role of money in economic transactions. The debate, which initially embraced only coins, was subsequently widened so as to include also paper money as well as all related matters, such as – in modern times - inflation.

At the Prophet's time, three types of metal were used as coins: gold (*Dinar*), silver (*Dirham*), and copper (*fals*, plural *fulis*). It follows that there were three different legal tenders at the time.

The quality of the first coins which were struck was poor (*i.e.*, the content of precious metal contained therein was very low), therefore people used to weigh them rather than counting them. Nonetheless, those coins were considered «object of trade with respect to their silver or gold content»[7].

As time went by, money started to be regarded as a medium of exchange with a conventional value, and counting prevailed over weighing as the preferred method of assessment.

From early on, Muslim scholars were faced with the challenging task of determining the exchanging rate between different coins and the rules governing them, along with the issue pertaining to coins containing a low amount of precious metal and whether the latter could be actually considered legally valid[8].

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was first reported across three unrelated societies, namely in China, in northeast India and in the areas surrounding the Aegean Sea between the 600-500 B.C. The main purpose of coinage was either to enable trade among parties who, due to the geographical or cultural, religious distance could not establish, a trust-based credit system or, additionally, in order to sale commodities that could not be simultaneously exchanged for other goods of equal worth. In particular, as to the area of the Aegean Sea, the first coins were minted in Lydia, under the kingdom of Croesus; thanks to their efficiency and ease of circulation, this method subsequently spread throughout the whole Greece, and, later on, it was adopted also by the peoples who traded with the Greeks. In ancient Rome, the first means of payment was the *aes rude*, *i.e.* raw bronze, whose value was determined on the basis of its weight; however, the Roman equivalent of Greek coins, namely *aes grave*, was introduced only at a later time. For a thorough overview of the historical development of money, see GNECCHI & GNECCHI (EDS.), *Rivista Italiana di Numismatica*, Milan, 1890. In any case, the advent of money was fueled by the necessity of an instrument which could easily circulate, be exchanged and stored over space and time and that would not give rise to disputes as to its value; in other words, a means of exchange.

[7] SIEGFRIED, *Concept of Paper Money in Islamic Legal Thought*, in *Arab L.Q.*, 2001, vol. 16, 319.

[8] An ongoing issue which would arise once again in relation to paper money.

Different stands were held by the various schools of Islamic law as regards the valid exchange rates between precious metal coins[9].

Later on, the introduction of paper money[10] transformed the entire paradigm of business transactions, shifting the previous legal debate on coins to the necessity to develop a concept of money, which was tailored to said new form of currency and, at the same time, was in accordance with the *Shari'a*.

Five approaches to paper money can be found in the classical Islamic legal writings: (i) paper money as a bond on the deposit of gold and silver, (ii) paper money as the replacement for silver and gold; (iii) paper money can be equated with *fulis* (*i.e.* copper coins, which were used as a «locally restricted currency for small transactions»[11], and whose intrinsic value was below the face (or exchange) value of said coins, which were therefore used as standards for prices of goods, like paper money is); (iv) paper money as a good whose value is determined by the market's supply and demand; (v) paper money as one form of currency among many others[12].

Drawing on these different approaches, Islamic jurists formulated a specific conceptualization of "money" that complied with the *Shari'a* precepts.

Under Islamic Law, money is considered a mere medium of exchange, which is devoid of any intrinsic value. In other words, currency acquires a value only as a medium of exchange, which cannot however be equated with a commodity that can be exchanged *per se*: therefore, making profit simply on money over a period of time is forbidden[13].

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[9] However, all jurists agreed that in case of partnership «one metal could be exchanged for the other only if both parties agree». It follows that in such a case no fixed rate of conversion was established and this allowed for floating exchange rates, paving also the way for «floating exchange rates between currencies». SIEGFRIED, *Concept of Paper Money in Islamic Legal Thought*, 319.

[10] The introduction of paper money throughout the Muslim world occurred during the nineteenth century in two steps: firstly backed by gold, and at a later stage, when the population started accepting it as a reliable system of payment, the gold standard was largely abandoned and paper money became the conventional money.

[11] SIEGFRIED, *Concept of Paper Money in Islamic Legal Thought*, 319.

[12] These different conceptualizations have been developed by the Islamic schools of law on the basis of their understanding of the *riba* prohibition. For a more comprehensive analysis of the Islamic ban on *riba*, if I may be permitted to reference my own work, see BORRONI, *A Comparative Survey on Islamic Riba and Western Usury*, 2014, (being printed).

[13] This original conceptualization of money in the Western world was further strengthened in the Middle Ages by the scholastic philosophers, above all, St. Thomas Aquinas who restated Aristotle's idea of money as barren, as a mere convention established by men for purchasing purposes, and which, as such, could not bear any fruits in itself, or better, it should not be employed for lending and demanding an increase in the principal as a reward for its use only. VISSER, *Islamic Finance Principles and Practice*, 40. Aquinas maintained that «all things that are exchanged must be somehow comparable. It is for this end that money has been introduced,

Specifically, money is not regarded as a commodity for the following reasons: (1) it has the technical (or artificial) property of yielding a real income to its owner simply by holding it, *i.e.*, without exchanging it against other goods; (2) it is liquid and does not have any carrying costs, nearly any production costs and cannot be replaced with a corresponding equivalent; (3) the

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and it becomes in a sense an intermediate; for it measures all things [. . .] . There must, then, be a unit, and that fixed by agreement (for which reason it is called money); for it is this that makes all things commensurate, since all things are measured by money». AQUINAS, *Commentary on the Sentences of Peter Lombard*, IV Book, III:37:1:6. Hence, money was considered to be devoid of any usefulness in itself, as opposed to commodities, while being regarded only as the measure of utility of other things. As argued also by Aristotle in his work ETHICS, Book 5, Chapter 5, in which the philosopher shows also a clear prevalence of the barter system. «Now proportionate return is secured by cross - conjunction. Let A be a builder, B a shoemaker, C a house, D a shoe. The builder, then, must get from the shoemaker the latter's work, and must himself give him in return his own. If, then, first there is proportionate equality of goods, and then reciprocal action takes place, the result we mention will be effected. If not, the bargain is not equal, and does not hold; for there is nothing to prevent the work of the one being better than that of the other; they must therefore be equated. (And this is true of the other arts also; for they would have been destroyed if what the patient suffered had not been just what the agent did, and of the same amount and kind.) For it is not two doctors that associate for exchange, but a doctor and a farmer, or in general people who are different and unequal; but these must be equated». This idea of money prevailed almost unchallenged until the so-called Christian retreat, *i.e.* the 16th century, when the expansion of commerce and the rise of the mercantile era (1500 – 1700) in Europe required a refinement of this conceptualization, as it was no longer workable under the changed circumstances. The initial criticism towards the Christian thesis about the infertility of money was drawn by Calvin who affirmed that the argument underpinning such idea was unfounded. Calvin expounded his arguments concerning usury in his work, CALVIN, *Letter of Calvin: De Usuris Responsum,* and clarified his position by means of an example: «Let us imagine a rich man with large possessions in farms and rents, but with little money. Another man who is not so rich, nor has such large possessions, has however more ready money. The latter being about to buy a farm with his own money, is asked by the wealthier for a loan. The lender may stipulate a rent or interest on his money and also that the farm may be the mortgage collateral until the principal will be paid, but until its payment, the lender will be content with the interest or usury on the loan. Why then shall this contract implying a mortgage (only for the profit of the money lent) be condemned, when a much harsher, it may be, of leasing or renting a farm at large annual rent, is approved?» Later on, in the 18th century, Jeremy Bentham in his work *Letter in defense of Usury* rejected the Aristotelian and Scholastic idea of money and paved the way for the notion of money that is currently and commonly shared among Western societies, that is, money has an inherent worth and one can actually gain profit from its use. BENTHAM, *Defense of Usury*, *Available at* http://www.econlib.org/library/Bentham/bnthUs1.html (last visited 17 July, 2014). Bentham regarded usury as a form of individual liberty and was in favour of the abolition of the anti-usury laws. Obviously the concept of money further changed over centuries since Bentham's time. Presently, money is deemed to have a twofold nature: it is an abstract unit of measurement and, at the same time, a medium of payment constituted by 'monetary pieces' (paper money or coins), which can eventually acquire the function of capital.

demand for money is not genuine as it arises from the demand for goods that can be purchased with it; (4) money is exempt from the law of depreciation which on the contrary applies to every commodity; and (5) money is the product of a social convention and possesses a purchasing power which derives mainly from States' sovereignty as opposed to the intrinsic value of goods[14].

As a consequence of this peculiar conceptualization, interest is considered by most Islamic scholars as a theoretical concept which neither corresponds to nor represents a real increase in capital. Therefore, charging interest on the money lent cannot be accepted, for the gain earned by the lender does not arise from any profitable investments[15]. And, even though the lender may be deprived of access to his money for a certain period of time, Islam regards time as a gift from *Allah* which cannot be valued in economic terms[16].

Besides, the notion of the "time value of money"[17] provides also the rationale for interest and interest rates in conventional financial matters, for the latter rely on the idea of the superiority of the present over the future[18]. Average people, in fact, tend to prefer present gains over future profits, and if they are required to temporally forgo the use of personal funds, they assume to be entitled to a sort of compensation, *i.e.*, interest. The rate of said compensation may vary, for, according to a well-known financial principle, the value of money changes over time due to the influence exercised by both interest and inflation, therefore money's purchasing power is likely to be different in the future.

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[14] RICHARDSON, *The Shari'ah Prohibition of Interest*, in *Trinity C.L. Rev.*, Vol. 11, 2008, 87.

[15] For a more detailed account on the requirement for equality in *riba* transactions, see PICCINELLI, *Il diritto agli interessi nei Paesi Arabi*, in *Diritto del Commercio Internazionale*, Roma, 1996, and EL-GAMAL, *Islamic Finance - Law, Economics, and Practice*, Cambridge MA, 2006.

[16] RICHARDSON, *The Shari'ah Prohibition of Interest,* 87. Again, if I may be permitted to reference my own work, for a different stand in this regard, see BORRONI, *Il danno da inadempimento del committente: per una ricostruzione evolutiva dell'inadempimento dell'obbligazione. Spunti di diritto comparato e comunitario*, in VV.AA., *Osservatorio di diritto comunitario e nazionale sugli appalti pubblici*, 2010, 1-59, arguing in favour of the compensation for damages arising from the unavailability of the amount of money lent. See also, PARDOLESI, *Interessi Moratori e maggior danno da svalutazione: appunti di analisi economica del diritto,* in *Foro it.*, 1979.

[17] Such represents is a subject matter of debate among Muslim scholars, for no unanimity has been reached as regards its acknowledgment so far. Some hold that the concept of a time value of money «is devoid of sense» (VISSER, *Islamic Finance Principles and Practice*, 36) and that no inflation compensation should be allowed, for «divine rule[s] cannot be relaxed for man-made problems» (*Id.).* It is evident, however, that a time-factor is recognized by the *Shari'a* at least in relation to sale transactions, in which a deferment in payment allows for a price increase.

[18] EL-GAMAL, *Islamic Finance - Law, Economics, and Practice,* 56.

As a result, some argue that the nominal interest rate represents a justifiable and fair compensation for inflation, as the value of money depreciates over time[19].

Nevertheless, Islamic scholars affirm that acknowledging that money's value changes over time does not necessarily entitle individuals to a right to an equivalent material compensation[20].

And Islam puts restrictions on such rewards, for interest-bearing loans are «prohibited as a means of material compensation for time»[21]. Furthermore, we shall bear in mind that Islamic law distinguishes between loans and investment: time is regarded as a factor contributing to a licit increase in the value of money only in case of an economic undertaking, because investing one's capital in a business venture means sharing both profits and losses as well as the taking of risks throughout the venture's duration, consequently the personal involvement entitles the parties to receive a return on the economic activity performed.

Whereas, loans are generally considered charitable acts which do not allow for any gains.

In addition, fixing interest rates *ex-ante* means establishing a certain return over uncertain profits/losses, which is forbidden since the outcome of a venture is generally unknown. It follows that time is considered a "facilitator" only in case of investments in economic activities, for the passage of time decreases the inherent uncertainty of business and leads to the latter's completion, along with the achievement of the relevant return.

So, the credit system poses a broader problem than the forbiddance of lending at interest, for even if the idea of time value of money succeeds in

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[19] CHOUDHURY, *Interest Rate And Intertemporal Efficiency In An Islamic Economy: Issue Revisited*, Jeddah, 1982, 40 s. The Author states that as regards inflation and growth within an Islamic economy it can be assumed that Islamic governments do not aim at capital accumulation *per se*, but they rather pursue equity and efficiency through growth process. The multiplier effect of growth is felt through the inter-temporal investments propensity which increases Islamic system's social welfare. Efficiency in such an economy is achieved through an atomistic market mechanism which relies upon the principle of cooperation and a mark-to market approach. It follows that, as all profits are normal profits, prices can never reach exorbitant levels and, therefore, neither cost-push inflation nor demand-shift inflation could inhibit the transitional system. So, some Muslim scholars argue that inflation could be monitored through macroeconomic policies, rather than accepting it as an unavoidable financial factor. (VISSER, *Islamic Finance Principles and Practice*, 36).

[20] IBRAHIM, *The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration*, in *Am.. U. Int'l L. Rev.*, 2008, vol. 23, 698.

[21] *Id.*

sneaking in, the acceptance of inflation[22] compensation remains debatable among Muslim scholars[23].

2. The *Riba* Prohibition

The Islamic concept of money has been built up around a number of religious precepts, stating, for instance, that gaining profit on the mere use of money is illicit or that one should lend money without requesting any reward for it.

But why is lending at interest actually forbidden under Islamic Law?

In order to answer such question it is necessary to describe the main features of the *riba* prohibition.

The ban on *riba* represents one of the main proscriptions of the Islamic law, alongside the prohibition of *gharar*[24] and *maysir*[25].

This prohibition reflects a fundamental Islamic principle: accumulating wealth through interests is not a proper way of earning, because it is passive and the related increase does not result from labour and risk-taking[26].

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[22] ANWAR, *Islamicity of Banking and Modes of Islamic Banking,* in *Arab. L.Q.,* 2003, vol. 18, 73 ss. See also GILANI - SAQIB, *Indexation of Loan in Conventional and Islamic Finance* (October 23, 2011). *Available at* SSRN: http://ssrn.com/abstract=1948208 or http://dx.doi.org/10.2139/ssrn.1948208 . The authors propose a study investigating indexation as a tool to protect both lender and borrower against the fluctuation of currency due to inflation within a given economy. Evidence shows that in both modern and classical Islamic Finance literature, no connection between index and loans or debts to balance out the impact of inflation on acquiring power of money was made, though the Shari'a does not prohibit to take preventive measures to contrast the decrease of the value of money in contracts.

[23] ANWAR, *Islamicity of Banking and Modes of Islamic Banking*, 73 ff.

[24] The ban on *gharar* concerns the excessive uncertainty and risk concealed in some financial transactions.

[25] The Arabic word '*maysir*' signifies gambling and speculation (VISSER, *Islamic Finance Principles and Practice*, 45). The ban on *maysir* is stated in three passages of the Qur'an (Sura 2:219, 5:90, 5:91), which warns against the ills of gambling, in particular, against *maysir*, which was the name of a game of chance played in the pre-Islamic period. This prohibition is linked to the ban on alcohol consumption, for both «caused enmity and distracted the faithful from worship». WARDE, *Islamic Finance in the Global Economy*, Edinburgh, 2000, 58.

[26] JENSEN, *Avoiding Another Subprime Mortgage Bust through Greater Risk and Profit Sharing and Social Equity in Home Financing: An Analysis of Islamic Finance and Its Potential As a Successful Alternative to Traditional Mortgages in the United States*, in *Ariz. J. Int'l & Comp. Law*, 2008, vol. 25, 825; AHMED, *Not Interested In Interest? The Case for Equity-Based Financing in U.S. Banking Law*, in *Entrepren. Bus. L.J.*, 2007, vol. 2, 485; WU, *Islamic Banking: Signs of Sustainable Growth*, in *Minn. J. Int'l L.*, 2007, vol. 16, 236.

However, determining the boundaries of the concept of *riba* is rather difficult since no precise definition of the notion is laid down in Islamic primary sources of law (namely, the Quran and the Sunna);[27] under Shari'ah the term *riba* «refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity»[28]. On the basis of this description, the notion of *riba* may be equated with interest, nonetheless such an equation it misleading because «some forms of interest [...]should not be considered forbidden *riba*»[29], since if they were, the overall commercial structure would be tainted with illegality. However, no unanimity exists among scholars as to the possibility to accept increases on the principal amount as generally valid[30].

So, given the complexity of the subject matter, and in order to shed some light on it, we should reference the Islamic sources of law, so as to grasp the actual meaning of the prohibition.

The Qur'an reads:

Allah hath permitted [sale]
And forbidden [riba].
Allah will deprive
[Riba] of all blessing,
But will give increase
For [voluntary] deeds of charity;
For He loveth not
Creatures ungrateful
And wicked[31].

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[27] SENIAWSKI, *Riba Today: Social Equity, The Economy, and Doing Business Under Islamic Law*, in *Colum. J. Transnat'l L.*, 2001, vol. 39, 702. See generally SEZNEC, *Ethics, Islamic Banking and the Global Financial Market*, in *Fletcher F. World Aff.* 1999, vol. 23, 161; BILAL, *Islamic Finance: Alternatives to the Western Model*, in *Fletcher F. World Aff.,* 1999, vol. 23, 146.

[28] AL-OMAR & ABDEL-HAQ, *Islamic Banking: Theory, Practice & Challenges*, London, 1996, 8. See also *Fatwa of Kuwait Finance House, al Fatawa al Shar'iyah*, in DELORENZO (ed.), *A Compendium Of Legal Opinions On The Operation Of Islamic Banking,* 1997, Question 270.

[29] IQBAL - MIRAKHOR, *An Introduction to Islamic Finance: Theory and Practice,* 2007, 55 - 56.

[30] For a discussion of the major differences among the Islamic schools of law, see generally KHAN, *The Schools Of Islamic Jusirprudence: A Comparative Study*, New Delhi, 1991.

[31] *Id.* (quoting The Meaning of the Holy Qur'an, IV:161 ('Abdullah Yusuf' Ali trans., ed. 1991).

On the basis of the quotation, it emerges that the *riba* prohibition does not prevent the possibility to lend money under Islamic law, but it merely forbids unearned profit (or, in other words, profit without expected and common business risks)[32]. It is worth bearing in mind that Islam developed out of a merchant environment, where trade was a fundamental aspect of life; consequently, the essential purpose pursued by the ban on *riba* was to avoid unlawful gain only, while profits earned by sharing business risks, especially the risk of default, were fully permissible.

Recompense «is the basic trait or the *conditio sine qua non* of a *halal* or lawful sale, because sale is necessarily an exchange of value against an equivalent value; an equitable return and compensation for the goods and services»[33].

Historically, this prohibition is closely linked to a pre-Islamic commercial habit that was named *riba* and which was made illegal by the *Qur'an*[34]. The Arab society, at the time of the revelation of the *Qur'an* (7th century C.E.), was characterized by a "natural economy" in which the majority of persons generally lived at a subsistence level under pressing needs, which forced them to take out loans from moneylenders and merchants to face critic situations such as a severe crop failure, a general famine or hostile raids[35]. When the borrower could not repay the loan by the agreed date, the sum of money that had to be returned to the lender was often doubled (or increased by large increments) in exchange for a delay in payment. As a result, the rate applied became exorbitant[36].

In order to stop such unfair practice, the Qur'an states:

O ye who believe!
Devour not riba,

[32] SENIAWSKI, *Riba Today: Social Equity, The Economy, and Doing Business Under Islamic Law*, 15 s. (recognizing that both the Pakistani Federal *Shari'aht* Court [in *Ur-Rahman Faisal v. Secretary, Ministry of Law, Justice, & Parl. Affairs, Gov't of Pak*., 44 P.L.D. 1 (1992)] and the Egyptian Supreme Constitutional Court [in *Rector of the Azhar University v. President of the Republic*, Case No. 1 (Sup. Constitutional Ct.) (Egypt), *reprinted in* Supreme Constitutional Court (Egypt) - *Shari'ah and Riba: Decisions in Case No. 20 of Judicial Year No. 1*, in *Arab L.Q.,* 1985, vol. 1, 100] while interpreting national laws based on *Shari'ah,* determined that interest falls under the definition of *riba* and it is therefore prohibited; MALLAT, *Commercial Law in the Middle East: Between Classical Transactions and Modern Business*, in *Am. J. Comp. L*., 2000, vol. 48, 125 ss.

[33] HAQUE, *Riba: The Moral Economy Of Usury, Interest And Profit*, II ed., 1995, 9, 7, 11; DURREZ AHMED, *Riba in Islamic Law*, in *Islamic & Comp. L.Q*., 1986, vol. 6, 57.

[34] Qur'an, II:275.

[35] *Id.*, 26, 33.

[36] *Id.*, 29.

Doubled and multiplied;
But fear Allah; that
Ye may (really) prosper[37].

The "doubled and multiplied" refers to the «repetition of the process of doubling from year to year»[38]. The pre-Islamic practice of allowing repayment deferral for an increase in the sum owed is the only habit clearly indicated in records as *riba*.

Thus, according to the Qur'an, *riba* is an inequitable exchange, destructive, and out of place in a fair economic order[39].

However, the concept of *riba* is not confined to money lending but it encompasses also the exchange of goods. The *Shari'a* recognizes, in fact, two forms of *riba*: *riba al-Nasiah* (excess on loans) and *riba al-Fadl* (excess on exchange)[40].

1. *Riba al-Nasiah* deals with *riba* in money-to-money exchanges and refers to the extra time granted to the borrower for the repayment of the loan, in exchange for an "addition" or "premium" charged by the lender. The practice of fixing in advance a positive return on a loan as a premium for such extra time is not allowed by the *Shari'a*[41] and this kind of *riba* lies at the basis of the prohibition of interest in today's financial transactions[42]. In simple terms, one should not be able to earn «money on money», since money is seen

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[37] Qur'an, III:130.

[38] HAQUE, *Riba: The Moral Economy Of Usury, Interest And Profit*, 35.

[39] DOI, *Shari'ah*: *The Islamic Law*, 1984, 381; ABDEL-FATTAH EL-ASHKER, *The Islamic Business Enterprise* 1987, 2; AMIN, *Banking and Finance Based on Islamic Principles - Law and Practice in Modern Iran*, in *Islamic & Comp. L.Q.,* 1989, vol. 9, 4.

[40] Professor Sanhuri identifies three different purposes for the prohibition of *riba*: to prevent hoarding, to guard against turning currency into a commodity over which to speculate, and to ban fraud and exploitation over the trade in items of the same genus. HAMOUDI, *The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law,* in *Am J. Comp. L.*, 2008, 450.

[41] HAMMAD, *Compensation for an Obligation to Sell Currency in the Future (Hedging*), in *Chi. J. Int'l L.,* 2007, vol. 7, 521.

[42] WU, *Islamic Banking: Signs of Sustainable Growth*, cit., 249 s., clearly states in other words that Islam prevents the reward for the time- value element. The reason for that is taken from an illustration of the Prophet using an unborn animal: «The price of a pregnant sheep should be increased in consideration of what it carries, even though the unborn animal itself could not be sold separately. Thus, time may be considered in setting a price, but it is not separable from the sold article, and the compensation for time is therefore included as part of the price of the article being sold» (*Id*., 250).

The reward for the time element is like rewarding the lender twice for the same product. The same author added that, in Islam, risk-taking and sacrificed liquidity should be compensated. *Id.*

as a mere medium of exchange which earns value only when it is commodified[43].

2. Riba al-Fadl deals with barter or exchange and its proscription stems from to the sayings[44] of the Prophet who required that commodities were exchanged for cash rather than by barter to prevent unfair behaviours. In fact, the diversity in quality of the items bartered can lead to mismatches in the quantity and quality of the exchanges, which may give rise to an unjust enrichment, *i.e.*, *riba*[45].

Nonetheless, it is worth highlighting that when money is converted into a commodity or a capital asset, these can be rented out, leased, or sold for a margin of profit, for, in this way, the lender is acquiring the rental value of an intrinsically valuable good and is not «earning money on money in itself» [46].

3. Basic Rules of Currency Exchange and Paper Money

Following the overview on the Islamic idea of money, the rationales underpinning it and the prohibition of *riba*, this paragraph will analyze the legal status of modern currencies under Islamic law.

The issue has been discussed in several forums and many leading Islamic institutions have ruled on the subject, among which the International Islamic *Fiqh* Academy[47].

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[43] BHATTI, *The Shari'ah And the Challenge and the Opportunity of Embracing Finance "Without Interest",* in *Colum. Bus. L. Rev.*, 2010, 214 - 215.

[44] The hadith reads «Gold for gold, like for like, hand to hand and any excess is riba. Silver for silver, like for like, hand to hand and any excess is riba; grain for grain, like for like, hand to hand and any excess is riba; salt for salt, like for like, hand to hand and any excess is riba; barley for barley, like for like, hand to hand, and any excess is riba, dates for dates, like for like, hand to hand, and any excess is riba. And if the kinds differ, then sell as you wish, so long as it is hand to hand». See HAMOUDI, *The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law*. cit., and SALEH, *Unlawful Gain and Legitimate Profit in Islamic Law,* II ed., 1992, 19- 20..

[45] Qur'an 30:39. BHATTI, *The Shari'ah And the Challenge and the Opportunity of Embracing Finance "Without Interest",* 214- 215.

[46] BHATTI, *The Shari'ah And the Challenge and the Opportunity of Embracing Finance "Without Interest"*, 215.

[47] The International Islamic Fiqh Academy is an affiliated institution of the OIC (Organization of Islamic Conference), whose main objectives are: (i) «to achieve the theoretical and practical unity of the Islamic Ummah» through the adherence to the Shari'a principles both at the individual and social level, (ii) «to strengthen the link of the Muslim community with the Islamic faith», and (iii) «to draw inspiration from the Islamic Sharia, to study contemporary problems from the Sharia point of view and to try to find the solutions in conformity with the

Let us, therefore, consider the main points of the resolution adopted by this institution:

- Gold and silver were the main means of exchange and the *'illah* underlying the *riba* prohibition in relation to these two metals was the fact of being *mutlaq al-thamaniyyah*[48], namely, money and medium of exchange. Therefore, the same *'illah* is not restricted to these two metals alone. On the other hand, paper money has replaced gold and silver in their current use, though it is through the latter that the value of things is measured. Moreover, people rely on and keep paper money as a store of value, and settle even debts through it.
- Paper money is considered an independent kind of currency as gold and silver, consequently, *riba* applies to it as it does to the latter. Thus, it is deemed illegal to buy and sell said currencies (either exchanging paper money or exchanging it for gold and silver) without taking possession of it at the time of the contract. Moreover, it is illegal to exchange different tenders of any of the aforementioned currencies with each other whether in a spot market or on deferred basis. It is however acceptable to exchange these currencies if the transaction is conducted on the spot[49].
- Paper money can be lawfully used as a price for *salam*[50] and as capital for partnership[51].

As it clearly emerges from the few points highlighted above, the lawfulness of spot currency exchanges is largely agreed upon by Muslim jurists, despite some contemporary jurists still consider it an illegal practice[52]. Nonetheless, such type of transactions are necessary to Muslim investors in order to manage the risks associated with currency fluctuations.

In particular, today's business managers need to know how the foreign exchange market works and how currency risk resulting from the modification in the value of money over time can be reduced. Difficulties, however, arise

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Sharia through an authentic interpretation of its content». *Available at* http://www.oic-oci.org/oicv2/page/?p_id=64&p_ref=33&lan=en#FIQH (Last visited 9 September, 2014).

[48] The Arabic expression refers to the broader characteristic of being money.

[49] It is legal to exchange, for instance, two Lebanese lira with two Saudi riyal if it is hand to hand.

[50] Under Islamic Law *salam* is defined as follows «the purchase of a commodity for deferred delivery in exchange for immediate payment» (AAOIFI Standard No 10, Salam and Parallel Salam, Shari'a Standards for Islamic Financial Institutions, AAOIFI, 2010).

[51] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston, 2008.

[52] KAMALI, *Islamic Commercial Law – An Analysis of Futures and Options*, The Islamci Text Society, 2001.

in relation to this point and specifically pertain to the existing forward currency market, which is not in line with the *Shari'a* principles[53].

It is plain that the problem of currency fluctuation is less important if the payment for goods, services or securities is made promptly. Spot market prices of foreign currencies usually change very little from day to day; however, if payment is deferred, the spot rate bears a strong and concrete uncertainty[54]. Therefore, in case of large sums of money, commercial traders attempt to guarantee the future price at which currency can be purchased; and this is precisely the function of the forward exchange market, which allows parties to reduce the risk involved in the deferred transaction by agreeing upon a price in advance[55].

This tool is used not only by borrowers, but also by traders, who engage in import-export ventures with foreign Countries. Nevertheless, many Muslim jurists claim that if the exchange of currency does not involve immediate receipt or taking possession of money, it is an illegal transaction. In particular, during the second conference of Islamic banks, it was established that «it is illegal to exchange gold, silver or currencies unless it is on the spot. Therefore, any exchange on future basis will be a kind of *riba*»[56].

Likewise, the Accounting and Auditing Organization of Islamic Financial Institutions'[57] Standard n°1 on Trading in currencies is very clear in this regard:

> It is prohibited to enter into forward currency contracts. This rule applies whether such contracts are effected through the exchange of deferred transfers of debt or through the execution of a deferred contract in which the concurrent possession of both of the counter values by both parties does not take place.

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[53] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets,* Boston, 2008.

[54] *Id.*

[55] Specifically, a forward exchange rate contract «is a contract to buy and sell a specified amount of different currencies for physical delivery of either side at some future date, calculated by reference to a contractually agreed strike price». *Id.*

[56] See *Abhath al-Mu'tama al-Thani li al-Nasrif al-Islami*, Kuwait, 1983, in AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*.

[57] The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an international independent Islamic body concerned with activities of accounting, auditing, governance and ethics and the issuance of Shari'a Standards that serve as guidelines for Islamic financial institutions and the Islamic Banking and Finance (IBF) industry at large. Available at http://www.aaoifi.com/en/about-aaoifi/about-aaoifi.html (Last visited 9 September 2014).

It is also prohibited to deal in the forward currency market even if the purpose is hedging to avoid a loss of profit on a particular transaction effected in a currency whose value is expected to decline[58].

Despite the disapproval of forward currency contracts on the part of Islamic jurists, Muslim economists tend to be in favour of them. For instance, as maintained by Mohammed Obahidullah:

Bay' al sarf[59] is defined in *fiqh* literature as an exchange involving *thaman haqiq*, defined as gold and silver, which served as the principle medium of exchange for almost all major transactions. […] The tradition mentioned about *riba* and the sale and purchase of gold and silver which may be a major source of *riba*, is described as *bay al-sarf* by the Islamic jurists. It should be noted that in *fiqh* literature, *bay al-sarf* implies the exchange of gold and silver only, whether these are currently being used as the medium of exchange or not[60].

On the basis of such argument, he affirms that «[t]he second type of contracting with deferment of obligations of one of the parties to a future date falls between the two extremes» and he adds that on the basis of his analysis «there is no possibility of earning riba with this kind of contract».

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[58] Accounting and Auditing Organization for Islamic Financial Institutions, *Shari'ah* Standards for Islamic Financial Institutions, 2010, Standard n°1 Trading in Currencies, par. 2.2, 2.3. The rationale for this ruling rests primarily on two *ahadith* (*i.e.*, the traditions of the Prophet) governing the rules of currency exchanges. The first hadith states, as reported by 'Ubadah Ibn al-Samit, «gold for gold, silver for silver, […] equal for equal, like for like, hand to hand, if the assets differ, you may sell them as you wish provided it is hand to hand.» And the second hadith, as reported by Abu Sa'id al-Khundri, reads «do not sell gold for gold except equal for equal and do not sell what is deferred for a spot exchange.» Hence, on the basis of these two *ahadith*, gold and silver are deemed to be of different nature and contemporary Islamic fiqh jurists have made a parallel between paper and coin money and gold and silver as referred to in the Prophet's words. It follows that trading in currencies is admissible for it is deemed to fall under the provision governing the sale of gold, silver and money as means to earning profit. Moreover, such trade is permitted as long as no reasons arises for considering it in violation of the Shari'a. To be more precise, in case of different currencies the amounts exchanged can be different, however the condition of taking possession of the counter-values at the moment of the signature of the contract must always be complied with. Whereas, in case of exchange of currency of the same kind, «equality of the countervalues and concurrent taking possession are required», see: Standard 1, Appendix B – Basis of the Shari'a Rulings, par. 3, AAOIFI *Shari'a* Standards, 2010.

[59] *Sarf* means trading in currencies and is regulated by the AAOIFI Standard No. 1 on Trading in Currencies.

[60] OBAIDULLAH, *Islamic contracts for currency exchange: divergent views and implications*, *Journal of Objectives Studies*, 1997, vol. 9 (2), 24 ff.

Since under such contract, he continues, at least one party is required to set his obligation, this naturally restricts the room for speculation. The requirement which he references «amounts to the imposition of a hundred percent margin, which, in all probability, would drive the uninformed speculator from the market». According to Obahidullah, «this should force the speculator to be a little more sure of his expectations by being better informed», and if the speculation is grounded on information, then it turns out to be a desirable type of speculation. Therefore, he concludes that «[b]ay' al-salam also allows participants to manage risk. At the same time, the requirement of settlement from one end would dampen the tendency of many participants to seek a complete transfer of perceived risk and encourage them to make a realistic assessment of the actual risks»[61].

Nevertheless, even though Obaidullah's analysis sounds convincing from a practical viewpoint, the lawful exchange of *fulus* on a *salam* basis could not be extended to paper money since there are clear differences between the two types of currencies. Hence, Obaidullah's conclusion is not underpinned by valid arguments from a strict legal perspective.

As a consequence, Muslim scholars have been engaged in conceiving suitable Islamic alternatives, which would, on the one hand, secure some benefits of forward currency exchanges without violating Islamic rules, while, on the other hand, acknowledging the advantages of forward currency trading in the modern economic system[62].

And this is how the idea of mutual promise in currency exchange has been developed.

3.1. The Legitimacy of Forward Currency Exchanges

Before focusing on the various legal tools which allow Muslims to circumvent the formal prohibition of forward currency exchanges, though granting them almost identical benefits, it is worth pausing on the arguments in favour of their validity.

Generally, compensation for a forward currency contract might be considered lawful if the contract contains the following three elements of wealth: (i) the obligation is to be regarded as an usufruct; (ii) the usufruct has a value; (iii) the usufruct is lawful[63].

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[61] *Id.*

[62] More details in: AL-AMINE - M. AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets,* Boston 2008.

[63] NAZIH, *Compensation for an Obligation to Sell Currency in the Future (Hedging)*, in *Chi. J. Int'l L.*, 2007, vol. 7, 524. It might be helpful to remind here that only if an item is

i. According to Islamic legal terminology an item has a "meaningful use" if it pursues a rightful objective (*i.e.*, attracting benefits or avoiding damage). Hence, based on this definition, a forward currency contract holds a 'meaningful use', in that people resorting to it aim at achieving a rightful purpose: repelling contingent or expected detriment arising from market fluctuations in the value of currency[64].

ii. Forward currency contracts have a commonly acknowledged monetary value regardless of the absence of this type of obligation in the past. To be more precise, the previous argument can be explained through one of the operative principle of the Shari'a, that is, a usufruct which was not considered wealth in former times can acquire such status «if it is accorded value at some other time»[65]. Such principle rests on custom that, owing to its specific nature, is deemed to change over time; consequently, those rulings relying on customary practices may change as well. So, forward currency contracts shall be regarded as lawful usufruct for they have been accorded value by commercial custom.

iii. Under *Shari'a* the lawfulness of a usufruct must be "certified" by a legal or a sacred text which clearly states its validity. Nonetheless, this is not regarded as a precondition in case usufructs or contracts in financial exchanges, which must rather comply with the content of legal and sacred texts. Hence, according to a well-known legal maxim: «anything that has to do with basic human necessities will be suitable as an object for contractual buying and selling. Only that which has been expressly prohibited by Allah or His Prophet will be prohibited because the precedent in all financial contracts and transactions is permission and lawfulness»[66].

Along with the aforementioned aspects, the lawfulness of a forward currency contract depends also on the purpose of purchasing such an obligation. If the purchaser aims at speculating on currency prices, rather than acquiring the currency, then the usufruct is deemed to be unlawful because it resembles

regarded as wealth can subsequently be exchanged for other wealth, otherwise it would be an unlawful transaction.

[64] *Id.* The author gives the following example, «in order to maintain production, merchants and manufacturers are required to import raw materials on a regular basis using deferred payments in one foreign currency or another. These merchants or manufacturers then sell the raw materials (or what they have become after manufacture) for local currency in cash, credit, as a part of export agreements, or by means of *salam* sales, *istisna',* or some other contract. By purchasing forward currency contracts, merchants and manufacturers can hedge against disastrous losses or even bankruptcy that can result from fluctuating exchange rates».

[65] *Id.*

[66] *Id.*

gambling, and therefore violates the *maysir* prohibition. Since such an obligation does not hold the characteristics of wealth (*i.e.*, true value), it cannot be exchanged for value and constitutes, therefore, a form of options contract which is prohibited under the Shari'a.

So, in compliance with Allah's words, a lawful sale occurs when the seller receives a price for the property sold and the purchaser pays the price to become the owner of said property. In so doing, both parties obtain from the transaction what they seek (*i.e.*, the former seeks the money and the latter seeks the ownership of the asset purchased). And, if the parties involved in the sale pursue said purposes, then the contract between them is deemed fully lawful.

However, the obligation arising from forward currency exchanges, though not implying an immediate fulfillment of both parties' goals, rests on the intention to take possession of the currency in the future; therefore, under certain circumstances, the usufruct of such obligation may be deemed to have value and, if so, can be legally compensated with money[67].

Thus, under *Shari'a* principles, the purpose of a contract is of great importance, because the intention underlying the parties' will to conclude an agreement determines whether the latter can be deemed lawful or not[68].

Two considerations may ground the legal justification of forward currency contracts under Islamic law: (i) the general legal orientation and (ii) the legal maxim concerning hardship.

As to the former, it draws on the opinions of the scholars belonging to the different Islamic schools of law as well as the Prophet's companions in relation to the generally acknowledged permissibility of monetary compensation for obligations including a useful and legitimate purpose (benefit). On the basis of such reasoning, it would be possible to draw parallels that would allow to establish the lawfulness of forward currency contracts[69].

Whereas, the second justification is based on one of the most common principles of the Shari'a, namely, «easing difficulties for people and relieving them of the responsibility for actions or omissions that would lead to undue

[67] NAZIH, *Compensation for an Obligation to Sell Currency in the Future (Hedging),* 525 ff. To give a concrete example, a buyer purchases the obligation because it is impossible to cover a real need for currency in the future and, in addition, in order to protect himself against contingent loss resulting from currency price fluctuations. Under said circumstances, it will be acceptable to recompense such obligations with money.

[68] The jurist al-Tasawwuli wrote that «everything that is taken for the purpose of [deriving from it] a legitimate benefit may be exchanged for wealth» (*Id.)*. Similarly, the jurists of the Hanafi, Maliki, and Zahiri schools (as well as some Hanbali jurists), permitted the buying and selling of anything in which there was a legitimate and purposeful use. *Id.*

[69] See: KAMALI, *Islamic Commercial Law – An Analysis of Futures and Options,* 1 ff.

hardship»[70]. In line with said principle, preventing people from contracting over obligations that are necessary to their wellbeing would cause them hardship; therefore, as a rule, all contracts that benefit individuals, while abiding by the *Shari'a* precepts, are deemed lawful. Forward currency contracts are stipulated by traders and manufacturers who purchase raw materials in foreign currencies and, at a later stage, sell the products made with said materials for payment in another currency. If those contracts were prohibited under Shari'a, those people would find themselves in straits and may even incur unbearable losses. As a consequence, forward currency contracts shall be legitimized to permit people[71] to safeguard themselves and their businesses against excessive and risky currency fluctuations.

It follows that, although forward currency exchanges might have been illegal in former times, the current need for such type of transactions within the present marketplace shall represent a valid and sufficient argument, along with the aforementioned ones, in favour of the legitimization of said obligations.

To sum up, monetary compensation for contractual obligation is deemed licit if the following requirements are met: (i) the party's purpose for contracting the obligation must be of real use to him, (ii) the use must be a lawful one; (iii) the use must have a monetary value recognized by custom; (iv) it must be possible to fulfill the obligation[72].

At this point, we should turn to the description of the different Islamic legal tools for currency exchange.

3.2. Islamic Tools For Currency Exchange

A. Mutual Non-binding Promise. The need for mutual non-binding promises for currency exchanges in modern transactions is evident especially in the import and export sectors owing to the unpredictability of currency and exchange rate fluctuations[73].

[70] *Id.*

[71] As a matter of fact the argument can be extended to all individuals or enterprises engaged in import-export activities, banks and other financial institutions as well as Countries.

[72] NAZIH, *Compensation for an Obligation to Sell Currency in the Future (Hedging)*, 524 ff.

[73] AL-AMINE-AL-BASHIR (ed), *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, 1 ff.

According to the majority of Muslim scholars any promise to conclude a foreign exchange transaction followed by a subsequent formal contract confirming it at a later stage is an illegal transaction. For instance, Ibn Juzai[74] cited three different opinions on the matter: the abhorrence of the promise of exchange, its permissibility and its ban. Whereas, Ibn Rushd[75] maintained that in the exchange of gold for silver, as well as in the sale of gold for gold and silver for silver, mutual promise, option, guarantee and assignment are not permissible, for only immediate delivery is possible. In addition, Ahmad Muhy al-Din[76] argued that a mutual non-binding promise is actually a contractual obligation, since the agreement must be executed at its maturity date. Moreover, such a promise is not always concluded with devout Muslims[77] and it is at variance with the principle of hand-to-hand delivery unanimously agreed upon by jurists as unavoidable condition in currency trading[78].

However, some Maliki scholars consider the mutual promise in *sarf* (or currency exchange) as a permissible legal transaction, al-Shaf'I, for instance, affirmed: «If two persons make a promise to each other to exchange foreign currency in the future, there is no problem»[79].

The main argument supporting the permissibility of said exchange is that a promise is not a contract and therefore no textual evidence exists disallowing such transaction. In that regard, Ibn Hazm highlighted the fact that: «to make a promise to someone to buy or to sell gold for gold, silver for silver and the four other items cited in the hadith, is legal whether the parties confirm this

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[74] IBN JUZAI, *al-Qawānīn al-Fiqhiyyah al-Sharʾiyyah, Maktabat ʿĀlam al-Fikr*, 1975, 263, in AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, 1 ff.

[75] *Passim* IBN RUSHD, *Bidāyat al-Mujtahid*, in AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, 1985, vol. 2.

[76] MUHYI AL-DĪN, *ʿAmal Sharikāt al-Istithsmār al-Islāmiyyah fi al-Sūq al-ʿĀlamiyyah, Bank al-Barakah al-Islāmī li al-Istithmā*r, Bahrain, in AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, 1986, 340 ff.

[77] This may occur because commercial deals could also be concluded with non-Muslims and morally corrupt persons who may not worry about defaulting on their obligations since there are no legal consequences for this kind of default.

[78] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, 1 ff.

[79] AL-SHĀFʿĪ, *al-ʾUmm*, Vol. 3, 32, in AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, 1 ff.

promise by a contract later or not. This is because exchanging promises is not a contract and there is nothing which prohibits it»[80].

Similarly, the same line of thinking emerges also from some modern Muslim scholars' writings. As a matter of fact, owing to the complexity of modern financial transactions and the need for different participation patterns in international trade, some jurists have suggested the adoption of the concept of promise so that to exchange different currencies, followed by a real contract confirming the transaction; this would represent a feasible solution to the problem of currency fluctuation[81].

As a result, many *Shari'a* boards of several Islamic financial institutions have started to approve this kind of transaction. For instance, the first seminar of Al-Baraka (a Saudi Bank) addressed the issue of whether making a promise to purchase different currencies at the rate of the day of the agreement, on the condition, however, that the mutual delivery of said currencies will take place hand to hand at a later date, could be deemed lawful.

According to Fatwa No 13 of the Seminar, this transaction was considered licit provided that the original promise was not binding on both parties[82]. Accordingly, the AAOIFI Standard No 1 sets in par. 2/9 that «a bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even for the purpose of hedging against currency devaluation risk. However, a promise from one party is permissible even if the promise is binding»[83].

B. Mutual Loan and Currency Risk Management. A further proposal for legal currency exchanges pertains to the idea of mutual loans. Bearing in mind that Muslim scholars are concerned with the problem faced by genuine traders, namely, how they could manage their investment risks without violating Shari'a rules, they developed the concept of mutual loan. The latter is a transaction whereby an Islamic bank and a genuine investor exchange an equivalent amount of money in different currencies for a specific period of time in the form of a mutual loan. During this period each party has the right

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[80] IBN HAZM, *al-Muhalla*, Vol. 2, 513 in AL-AMINE - AL-BASHIR (eds), *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[81] AL-AMINE-AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[82] *Id.*

[83] Cfr. AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010, Standard 1. The prohibition of binding bilateral promises in currency exchanges is predicated by most Shari'a jurists for, in the first place, such promises would be equivalent to a contract and, secondly, said promises are not followed by the taking possession of the counter-values. See Appendix B – Basis of the Shari'a Rulings, par. 7, Standard No 1, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

to use the amount of money received and is required to return the amount lent on the agreed upon date[84].

Nonetheless, this formula can be useful only if both parties have the required amount of money before entering the mutual exchange of *qard hasan*[85].

C. Currency Basket And Risk Management. The solution proposed by Saud Mohammad draws on the notion of currency basket. An importer facing the risk of currency fluctuation may make an arrangement with the owner of the commodities to be imported establishing that the settlement of the price will be made in many different hard currencies. As a consequence, any depreciation in any of said currencies (e.g. the US dollar, the Euro, the Swiss franc, etc.) will be balanced by the appreciation of the others; in this way, the investor could, at least to some extent, manage the risk of currency fluctuation[86].

The shortcoming of this formula lies in the fact that it can be helpful only to importers. Businessmen involved in export oriented trade should invest, instead, in Countries that do not place many conditions on exports, for, in so doing, when the currencies of those States depreciate, they will be able to increase their exports, thanks to the greater competitiveness of their products on the global market.[87] Nonetheless, this solution does not sound convincing in relation to exporters either, since they must always take into account the aforementioned conditions in order to successfully fulfil it, and this overtly subjects them to limitations.

D. Managing Price Fluctuation Through Deposit. In addition to the previous tools, an importer may also purchase the amount of currency needed for the settlement of his obligation and deposit it in an Islamic bank. Afterwards, at the time of the obligation's settlement, he withdraws the amount deposited. However, this solution requires the investor to have the money at hand at the beginning of the transaction[88].

E. Cooperative Funds And Currency Risk Management. A final solution to tackle the issue of currency fluctuation deals with cooperative funds. The parties involved in the import-export trade may establish a cooperative fund into which each party deposits a certain amount. Later on, the parties

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[84] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[85] *Id. Qard* is defined as «the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it» (AAOIFI Standard No 19, Qard, Shari'a Standards for Islamic Financial Institutions, AAOIFI, 2010).

[86] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[87] *Id.*

[88] *Id.*

would share the profits arising from the fund and, at the same time, they would be able to bear any risks associated with currency fluctuation[89].

This solution represents the manifestation of the profit-loss-sharing schemes.

3.2.2 Major Shortcomings

Despite the advantages brought forth by the aforementioned solutions, their deficiencies cannot be disregarded either.

In the first place, if the mutual promise is related to permissible transactions, then, the one who makes the promise should fulfill it.

Nonetheless, Muslim scholars disagree as to whether said fulfillment is mandatory or merely recommended[90]. Most of them considered it to be recommended, therefore, if someone fails to keep his promise, he will merely miss the reward he may obtain in the Hereafter.

Whereas, other scholars[91], regard the fulfillment of a promise as compulsory; and, as a consequence, if someone fails to keep it, he will be forced by the court to fulfill his obligation[92].

Among the Islamic Schools of Law, the Malikis expressively support the legal status of promise[93]. And the widely accepted opinion in relation to mutual promise is that if the promisee, by relying on a promise, enters into some financial obligations, then the party which has made the promise should be obliged by the court to fulfill it as a contractual obligation.

Thus, the final resolution of the Islamic Fiqh Academy in its fifth session stated that «a promise is binding from the religious point of view except when there is an acceptable excuse. It is also binding in the court of justice if the

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[89] *Id.*

[90] According to the AAOIFI Shari'a Standard No 1 on trading in currencies, an agent can be appointed «to execute a contract of sale of a currency with authorization to take possession of and deliver the countervalue». Furthermore, it is also permissible to «appoint an agent to sell currencies without authorizing him to take possession of the amount sold, provided that the principal or another agent takes possession at the closing of the transaction, before the principal parties are dispersed». The rationale underlying the permissibility of agency in exchange of currencies lies in the fact that «agency is permissible with regard to an activity that the principal could undertake personally». See: Standard 1, Appendix B – Basis of the Shari'a Rulings, par. 5, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[91] Such as for instance Ibn Shubruma, as reported by Amine and Bashir in their work (AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008).

[92] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[93] *Id.*

promise is dependent on certain reasons and the one promised has incurred some costs as a result of the promise»[94].

Whereas, the concept of spot foreign exchange is defined as an agreement to deliver a pre-determined amount of foreign currency at an agreed price, usually within one or two business days or even on the same day[95].

In addition, the majority of the current spot transactions occur *inter absentes*, namely via electronic means, and this aspect, coupled with the delay in the delivery, may actually pose some problems from the point of view of classic Islamic law.

Saud Mohammad[96], for instance, argues that considering such a transaction as a spot transaction is misleading from the Islamic point of view. He maintains that the exchange of offer and acceptance through electronic means cannot be considered an actual delivery because the latter will take place only when the other party has withdrawn the exchanged money from his account or he is likely to do so. Hence, according to him, modern spot foreign currency exchanges could not be regarded as spot currency transactions.[97]

Nonetheless, the Islamic *Fiqh* Academy, has ruled that the delay in recording the transaction is acceptable, even though it temporarily prevents the beneficiary from really taking possession of the currency. However, the beneficiary should not make use of the money until he receives the confirmation of the real delivery[98].

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[94] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[95] ROSE, *Money and Capital Market—The Financial System in the Economy*, in *Business Publications*, 1986, 791.

[96] AL-RUBAYA', *Taḥwīl al-Maṣrif al-Ribawī ilā Maṣrif Islāmi Wa Muqtadayātuhu, Markaz al-Makhtūtāt wa al-Turāth wa al-Wathāʾiq*, Vol. 1,1992, 278, in AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[97] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, cit. This stand contradicts however the AAOIFI Shari'a Standard on trading in currencies which approves of the use of modern means of communication in currency trading. AAOIFI ruling on the matter draws on the decision issued by the International Islamic Fiqh Academy pertaining to permissibility of concluding a contract via contemporary means of communications, such as fax, internet (Decision No 52 (3/6)). Cf. Standard 1, Appendix B – Basis of the Shari's Rulings, par. 6., AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[98] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008. Under AAOIFI Standard 1, it id laid down that «an offer made for a stated period, which is transmitted by one of the prescribed means of communication, remains binding on the offeror during that period. The contract is not completed until acceptance by the offeree, and taking possession of the countervalues (either

So, although some scholars still disagree on the legal validity of forward contract in the commodity market, the general principles of Islamic law do not reject it outright[99].

4. Instruments Of Credit Under Islamic Law: *Hawala* and *Suftaja*

Under Islamic law debt rights are transferable, and the permissibility of such transfer is of utmost importance, since the change of debtor (in Arabic '*hawala'* or transfer of debt) is one of the acceptable instruments of credit mentioned in Islamic legal sources, along with *suftaja*, or "letter of credit"[100].

4.1. *Hawala*

The description of *hawala* differs from one school of law[101] to another (whereas, scarce attention is paid to *suftaja*).

According to the AAOIFI Shari'a Standard No 7, *hawala* is defined as «the transfer of debt from the transferor (*Muheel*[102]) to the payer (*Muhal Alaihi*[103]). […] [Hence] a debtor is replaced by another debtor»[104].

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actual or constructive) by both parties, has taken place», moreover, a delay in making the transfer is permitted to the institution, but the payee is not allowed to dispose of the currency during the transfer period. Cfr. Standard 1, par. 2/6 –possession in sales of currencies, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[99] AL-AMINE - AL-BASHIR, *Risk Management In Islamic Finance – An Analysis Of Derivatives Instruments In Commodity Markets*, Boston 2008.

[100] In addition to these two instruments, other credit papers exists, such as *ruq'a* ("note") and *sakk* ("cheque").

[101] As Islam spread throughout the African and Asian continents, a major sectarian division arose within the Islamic community, namely the separation between Sunni and Shi'ah traditions. Each group subsequently developed its own schools of Islamic jurisprudence, which differ, especially in relation to the authoritative interpretation of the Shari'a. By the tenth century, Sunnis had founded four orthodox schools of law: the Hanbali School, the Hanafi School, the Maliki School and the Shafi'i School. Compare: LEWIS - ALGAOUD, *Islamic Banking*, 2001, 23-24, and WARDE, *Islamic Finance in the Global Economy*, 31.

[102] The *Muheel* represents the transferor, *i.e.* «the principal debtor and who usually refers his creditor to a third party for the collection of the debt.» AAOIFI Shari'a Standard No 7 - Appendix C: Definitions, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[103] This is «the party accepting the debt liability that will be collected from him by the transferee». *Id.*. The third party to this transaction is the creditor, which is called *al-Muhaal* or transferee, namely «the party who accepts the offer to collect his due from the transferor's debtor». *Id*.

[104] AAOIFI Shari'a Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

So, *hawala* represents the transfer of the obligation from one debtor to another, and implies also the transfer of the right to payment from one creditor to another.[105]

From a legal viewpoint, *hawalat al dayn* is defined as «the shifting or assignment of debt from the liability of the original debtor to the liability of another person»[106]. Essentially, it is the substitution of one obligor for another with the agreement (consent) of the creditor. Such transfer of obligation resembles the concept of novation of debt under Common Law, whereby a new debt or obligation is substituted with an existing one[107].

Though being classified under different headings by the different schools of Islamic law, this instrument functions essentially as follows: X (the transferee) owes a debt to Y (the transferor), and Y owes a debt to Z (the creditor). Y delegates the debt owed to him by X to Z, so that X will owe a debt to Z, but Y will be liberated[108]. Additional aspects of this formulation vary according to the schools, such as: the contracting parties whose consent is necessary

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[105] *Id.* It is a requirement for the conclusion of a valid *hawala* that the transferor be a debtor to the transferee. *Id.*

The structure of *hawala* may to some extent be equated with a legal institution of Italian law, named *modificazione soggettiva del rapporto obbligatorio da parte passive,* that is the possibility granted to the passive party to a debtor-creditor relationship to modify the contractual terms. Under Italian law, however, as opposed to Islamic law, on the basis of different circumstances, three diverse forms of such modification may apply: *accollo* (art. 1273 Italian Civil Code), *delegazione di pagamento* (Art. 1269 Italian Civil Code) and *espromissione* (art. 1272 Italian Civil Code).

[106] ZAYLA'I, *Tabyin al Haqa'iq*, Vol. 4, 1717, *as cited* in MANSURI, *Islamic Law of Contract and Business Transactions,* New Delhi, 2006, 301.

[107] Cfr. The Black's Law Dictionary. As established in the relevant Shari'a Standard «a contract of hawala can be concluded by an offer from the transferor and acceptance from the transferee (Muhaal) and the payer in a manner that clearly indicates the intention of the parties to conclude a hawala contract and the transfer of the liability or obligation in respect of a debt or right from one party to another party.» AAOIFI Shari'a Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[108] Under *Shari'a* freedom of contract is restricted, not only by the well-known ban on *riba* and *gharar*, but also by the impermissibility to combine contracts by making their outcome contingent on each other. The basis for this forbiddance are the following two ahadith: (i) «(the Prophet) forbade a sale and a stipulation» (by Abu Dawud in VOGEL-HAYES, *Islamic Law And Finance: Religion, Risk, And Return*, 1998, 68), (ii) «the Messenger of the Prophet forbade two bargains in one» (by Ibn Hanbal in *Id.*). Combination of contracts, especially of sale contracts, is forbidden because it leads to uncertainty as to the contractual terms, which may, in turn, bring in *riba* and/or *gharar* elements. The Hanbali scholar Ibn Taymiyya rejects, however, only the combination of onerous and gratuitous contracts, for such an arrangement can easily disguise an illicit profit. This view is shared also by modern Islamic scholars who forbids only those combinations that breach the basic *Shari'a* principles. Moreover, in the current IBF practice, combining contracts in an informal manner, namely without directly linking their stipulations,

for the *hawala* to be valid; the necessity (or not) of a pre-existing debt owed by the transferee to the transferor; the recourse the creditor will have against the original debtor (transferor), if the new debtor (transferee) does not pay; etc.[109].

It follows that under Islamic law the transfer of debt to third parties (*hawalat al dayn*) is a universally accepted concept with a broad commercial application.

There are two forms of permissible *hawala*: restricted and unrestricted. The former is «a transaction where the payer is restricted to settling the amount of the transferred debt from the amount of a financial or tangible assets that belongs to the transferor and is in the possession of the payer.»[110] Whereas, the latter «is a kind of transfer of debt in which the transferor is not a creditor to the payer and the payer undertakes to pay the amount of the debt owed by the transferor from his own funds and to have recourse afterwards to the transferor for settlement, provided that the transfer for payment was made on the order of the transferor»[111].

So, *hawala* amounts to a set of rules that fall within the scope of the law of obligations, which, in practice, is also transposed into operational rules that form the legal fundamentals which shall be observed in order to conclude a valid contract under Muslim law.

Historically, the practice of transferring debt obligations to third parties was common among Muslims since ancient times, and no report actually exists that disapproves this operation[112].

The Prophet Muhammad expressly stated and encouraged the transferability of debt obligations so as to facilitate the repayment of debt within the

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is deemed permissible. (*Id.*, 101-102). It follows that, although the fulfilment of a *hawala* contract implies the accomplishment of more arrangements in a row, this agreement cannot be regarded as a combination of contracts, since it is the transfer of an obligation to another party which does not entail any unlawful return.

[109] The debt transferred by means of *hawala*, though usually being in currency, can theoretically imply other goods, with the exception of foodstuffs. RAY, *The Medieval Islamic System Of Credit And Banking: Legal And Historical Considerations*, in *Arab L.Q.*, 1997, vol. 12, 60.

[110] AAOIFI Shari'a Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010. The permissibility of restricted *hawala* is endorsed by all schools of Islamic Law. *Id*., Appendix B.

[111] AAOIFI Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010. The word "payer" that is used in the AAOIFI Standard at issue is an alternative expression to the term "transferee", with an equal meaning. This second form of *hawala* contract is accepted by Hanafis only. AAOIFI Standard No 7, Appendix B. AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[112] *Id.*

society at large. As a matter of fact, *hawala* represents «an independent contract made out of courtesy»[113] whose acceptance on the part of the transferee is recommended as long as «the potential payer is known to be solvent and a person who honours payments»[114]; in so doing, the *hawala* contract is deemed to benefit the creditor and relieve the debtor's burden[115].

The legitimacy of *hawala* stems from the Qur'an, the Sunna, the legal reasoning and the consensus of the community. In particular, one hadith is considered the fundamental source of the legality of this instrument: the Prophet said «default on payment by a solvent debtor is unjust, and if anyone of you is transferred to a solvent person, he must accept the transfer»[116]. Another version of the same hadith reads, «if one is referred to a solvent person for the recovery of his right, such a person must accept the transfer»[117].

From the Prophet's saying, Muslims inferred that debt (i) obligations may be lawfully transferred, (ii) that such transfer fully discharges the transferor from any liability and claims and that, consequently, (iii) the transferee is the one to be pursued for the repayment of the debt obligation[118].

These concise conclusions are further clarified and expounded on in the section of the AAOIFI Shari'a Standard pertaining to the effects of the *hawala* contract on the three parties involved.

In the first place, it is laid down that in «a valid hawala […] the transferee will have no right of recourse against the transferor for payment. However, if the acceptance of the transfer was based on the condition that the payer must be solvent, then the transferee will have a right of recourse if the payer is not solvent»[119]. As a rule, the legal effect of *hawala* is to discharge the transferor from any liability and claims in respect of the debt: since the transferee has received his right to payment by the payer, as a consequence of this transfer, the transferee can no longer ask the transferor to pay. If such a request occurs,

[113] AAOIFI Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[114] *Id.*

[115] *Id.*

[116] As reported by Al-Bukhari (3/13) and Muslim (3/119), quoted from the AAOIFI Sharia Standard No 7- Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[117] As reported by Ahmad and al-Bayhaqi. AAOIFI Shari'a Standard no 7- Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[118] BALALA, *Islamic Finance And Law. Theory And Practice In A Globalized World*, 2011, 117.

[119] AAOIFI Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

it would imply a disregard of the fact that a transfer has occurred and has changed the original contractual terms between the two parties[120].

Furthermore, the permissibility for the transferee to have recourse against the transferor[121] in case the payer fails to pay (and the former had accepted the transfer precisely on the basis of the stipulation that the latter would be solvent), rests on the hadith stating «Muslims are bound by the conditions they made»[122].

As to the relationship between the transferor and the payer under a restricted *hawala*, the former can no longer claim from the payer an amount transferred to the latter in respect of the debt to be settled, for upon the contract conclusion and precisely by virtue of said contract, the right to payment has been transferred to the transferee[123].

Concerning the effect of the *hawala* contract on the relationship between the transferee and the payer, the *Shari'a* Standard sets that «the transferee is entitled to claim the amount of the debt assigned to him through *hawala* from the payer. The payer, on the other hand, is obliged to pay him and has no right to refuse payment» since «the payer takes the place of the transferor in respect to all rights, legal protections and obligations»[124]. The reason for this stipulation draws on the subject matter of *hawala*, *i.e.*, the transferor's debt. Since through this contract, the debt is passed to the payer, along with the debt, the payer acquires also all rights associated with the securities pertaining to said debt[125].

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[120] AAOIFI Standard No 7 - Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[121] The Standard lays down also four other circumstances under which the transferee has a right of recourse against the transferor, namely: (i) in case the payer dies in bankruptcy, (ii) if the payer goes bankrupt before the payment as a consequence of liquidation, (iii) if the payer is declared bankrupt during his life or refuses to conclude the *hawala* contract and has taken a judicial oath to this effect that cannot be denied, (iv) if the payer in the form of an institution is declared bankrupt by a court order. (AAOIFI Shari'a Standard No 7). Hanafi jurists justify the transferee's right to have recourse against the transferor in the aforementioned situations, on the basis of the hadith (reported by Ibn Qudamah, al-Mughni 4/339), in which Ibn Affan affirmed that «the transferee is entitled to return to the transferor for payment, as the right of a Muslim cannot go unfulfilled». AAOIFI Shari'a Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[122] AAOIFI Standard No 7- Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010. This precept mirrors the Civil Law principle of *pacta sunt servanda*.

[123] AAOIFI Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[124] *Id.* In case of a restricted *hawala*, the transferee «takes the place of the transferor in respect to all rights, legal protections and obligations against the payer». *Id.*

[125] AAOIFI Standard No 7- Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

In addition to these provisions, the *Shari'a* Standard sets a number of conditions that must be observed in order to conclude a valid *hawala*:

(i) «hawala is a binding contract. Therefore, it is not subject to unilateral termination»[126]. This means that it can be terminated only with the mutual consent of the parties, or if the transferee decides to write off the debt. Naturally, «a hawala liability will come to an end by settlement of the debt»[127];

(ii) «It is a requirement that the transfer of debt take effect immediately, not to be suspended for a period of time and not to be concluded on a temporary basis or contingent on future events»[128];

(iii) the transfer requires the consent of all three parties (creditor, debtor[129] and transferee), and «it is a condition that all *hawala* parties be legally competent to act independently»[130];

(iv) the creditor should accept the transfer as long as the transferee is solvent[131] (this being in line with the underlying purpose of *hawala*, that is, facilitating the repayment of debt obligations)[132].

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[126] AAOIFI Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[127] *Id.*

[128] *Id.* The specific nature of the *hawala* contract consists in the «immediate transfer of the debt to the payer» (*Id.*, Appendix B). Hence, once the transferee accepts, the payer and the transferee enter into a new contractual relationship, consequently the conclusion of the contract of *hawala* cannot be postponed nor can it depend on contingent events. *Id.*

[129] «The validity of a hawala requires that the transferor be a debtor to the transferee. A transaction in which a non-debtor transfers another is an agency contract for collection of the debt and not a transfer of debt» *Id.*

[130] *Id.* The consent of all three parties is an unavoidable requirement for the conclusion of a valid *hawala* contract, owing to three different reasons pertaining to the diverse parties, namely: (a) the transferor's consent is necessary so as to prove that he wants a third party to pay the debt on his behalf; (b) the transferee's consent is required because the contract implies the transfer of his "right to payment from the transferor as debtor to another person (the payer)" (AAOIFI Shari'a Standard No 7, Appendix B); (c) the payer must consent to the *hawala* for this contract makes him liable for payment, consequently he has to accept such liability in order to conclude a licit transfer. AAOIFI Shari'a Standard No 7 - Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[131] The Sharia Standard sets in this regard that «if the financial status and creditworthiness of the potential payer are unknown, then the hawala becomes mubah (permissible)» (AAOIFI Shari'a standard No 7), because the order included in the aforementioned hadith does not require the payer to be solvent as a condition for a valid *hawala*. Therefore, even if the payer is not solvent, the transferee can accept the contract. AAOIFI Shari a Standard No 7- Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[132] BALALA, *Islamic Finance And Law. Theory And Practice In A Globalized World*, 115. In compliance with the AAOIFI Standard No 1, «an exchange of amounts denominated in currencies that are debts established as an obligation on the debtor are permissible, if this results in the settlement of the two debts in place of a bilateral exchange of currencies, and in the

Besides, it is worth adding that among the diverse Islamic Schools of Law the Hanafi law regards *hawala* as a contract of surety, namely «it signifies the removal or transfer of a debt, by way of security and corroboration, from the faith of the original debtor, to that of the person on whom it is transferred»[133].

a.Modern applications of *Hawala.* *Hawala* represents a rather adaptable instrument of credit with a wide range of applications in the modern economic and financial context.

In particular, a form of *hawala* is commonly employed in case of withdrawals from current accounts. Specifically, «an issuance of a cheque against a current account is a form of *hawala* if the beneficiary is a creditor of the issuer or the account holder for the amount of the cheque, in which case the issuer, the bank and the beneficiary are the transferor, the payer and the transferee respectively»[134]. It is a requirement that the beneficiary be a creditor of the issuer of the cheque, for an existing debt is an unavoidable element for the conclusion of an *hawala* contract.[135]

Furthermore, *hawala* may be used to carry out overdraft operations. The relevant AAOIFI Standard sets in this regard that «if the beneficiary of the amount of a cheque is a creditor to the issuer, then issuing a cheque against the account of the issuer without a balance is unrestricted transfer of debt if the bank accepts the overdraft»[136].

Moreover, also traveller's cheques and bills of exchange amount to forms of the *hawala* contract. In the first case, «the holder of a traveller's cheque, the value of which has been paid by him to the issuing institution, is a creditor to such an institution. If the holder of the traveller's cheque endorses the cheque in favour of his creditor, it becomes a transfer of debt in favour of a third party against the issuing institution that is a debtor to the holder of the traveller's cheque. This is a restricted transfer of debt»[137].

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fulfilment of the obligations in respect of these debts». The rationale for the permissibility of this type of exchange is that it entails the settlement of the debt by discharging it and, in addition, it does not imply any prohibited transaction pertaining to debts. See Standard 1, appendix B – Basis of the Shari'a Ruling, par. 8, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[133] Ray, *The Medieval Islamic System Of Credit And Banking: Legal And Historical Considerations*, 61.

[134] AAOIFI Shari'a Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[135] *Id.*

[136] *Id.*

[137] *Id.*

Whereas, «a bill of exchange is a form of hawala if the beneficiary is a creditor to the drawer»[138]. In this case, the drawer is the transferor, the party executing the payment ordered by the drawer is the payer, and the beneficiary of the payment, namely the party holding the bill, is the transferee.

Besides, concerning the endorsement of negotiable instruments (e.g. cheques or bills of exchange), if such an operation transfers the title to the value of the instrument to the beneficiary, who, in turn, is a creditor to the endorser, then the deal is regarded as an *hawala* contract[139].

All the aforementioned practices are permissible under Shari'a for they simply constitute practical applications of the concept of *hawala*[140].

The last modern usage of *hawala* involves remittances, and though being permissible, a specification is due. If a customer requests an institution to transfer a certain amount of money in the same currency from his account to a beneficiary, this transaction is considered a transfer of debt provided that the customer is a debtor to the beneficiary. However, «if a remittance is to take place in a currency different from that presented by the applicant for the transfer, than the transaction consists of a combination of currency exchange and a transfer of money»[141], which must comply with the requirements sets in the abovementioned AAOIFI Standard No 1 on trading in currencies[142].

In practice, the ultimate effect of a *hawala* contract consists in giving another party the responsibility of carrying out a specific operation, which is therefore rather similar to the delegation of payment largely used in Western systems. Nonetheless, the major difference between a *hawala* contract and a conventional delegation of payment (e.g. purchases through credit cards or bank transfers orders) lies in the fact that the former requires a debtor-creditor relationship between the party accepting the liability and the party transferring it, whereas, in case of the latter, no pre-existing debt supports the legitimacy of said transaction. The peculiar requirement for the conclusion of a *hawala*

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[138] *Id.*

[139] The AAOIFI Shari'a Standard No 7 sets that «it is not permissible to discount bills of exchange by transferring the ownership of their value, before their due date, to an institution or others for a discounted immediate payment. This is because the transaction in this manner is a form of riba» *Id.*

[140] *Id.*, Appendix B.

[141] AAOIFI Shari'a Standard No 7, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[142] The international Islamic Fiqh Academy has issued the Resolution No. 8 (1/9) establishing the lawful solutions for the combination of transfer of money (banking remittances) and currency exchange. *Id.*

contract serves the purpose of distinguishing it from an agency[143] contract, which though being permissible, has to comply with different rules.

***b.Hawala* As An Informal Fund Transfer System.** As stated above, among the various practical applications of *hawala* in the current economy there is the transfer of money or remittance. This use of *hawala* shall be further expounded on in order to explain the significant role that this instrument plays across Countries.

In the first place, it is worth specifying that the informal transfer systems constitute in some States «the dominant means by which financial transfers are conducted», and, in some cases, these services are openly provided, «with or without government recognition», involving «cross-cultural and multi-ethnic aspects»[144].

Hawala, whose meaning in Arabic is "transfer", may be – and actually is – employed as a type of informal fund transfer system, namely as a mechanism used to transfer money which is parallel to or exists in the absence of conventional banking channels[145].

In practice, an *hawala* transaction implies a financial transfer which is made between customers who are located in two different Countries, and is carried out by the *hawala* service providers of the respective Countries, which «operate outside the formal financial sector»[146].

In general, the *hawala* transaction implies four parties: the remitter, two *hawala* service providers (intermediaries) located respectively in the remitter's State and in the recipient's State, and the recipient.

The remitter pays a sum of money (e.g. 1000 Euros) to a service provider in the Country where he lives/works (e.g. Germany), who, in turn, arranges the payment to the recipient by asking the *hawala* service provider of the recipient's State (e.g. Pakistan) to advance the equivalent amount of money in the local currency. Once the transaction has been completed, in other words,

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[143] The AAOIFI Shari'a Standard No 23 on Agency and the Act of an Uncommissioned Agent, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010, defines agency as «the act of one party delegating the other to act on its behalf in what can be subject matter of delegation» *Id.*

[144] QORCHI – MUNZELE MAIMBO - WILSON, *Informal Funds Transfer Systems, An Analysis of the Informal Hawala System*, IMF Occasional Paper No.222, 2003, 16. For an analysis of the extent of the use of informal fund transfer systems worldwide, see FREUND - SPATAFORA, *Remittances: Transaction Costs, Determinants, and Informal Flows*, World Bank Policy Research Working Papers No. 3704 (August 2005). *Available at* SSRN: http://ssrn.com/abstract=803667.

[145] EL QORCHI – MUNZELE MAIMBO -WILSON, *Informal Funds Transfer Systems, An Analysis of the Informal Hawala System.*

[146] *Id.*

when the recipient has received the money, the principals, *i.e.* the remitter and the recipient, cease to be part of the deal; whereas, the intermediaries have to clear and settle the transaction between them, because the intermediary in the recipient's Country has a claim on the intermediary in the remitter's Country. The intermediaries may settle their positions in different ways, also by resorting to «simple or complex reverse *hawala* transactions»[147].

The abovementioned informal *hawala* system is largely used across Muslim and non-Muslim Countries[148] due to a number of advantages it brings forth, namely: it is fast, cost-effective, culturally convenient, versatile and potentially anonymous.

In more detail, the period of time needed to accomplish such transfers depends on the locations of both the remitter and the recipient: for instance, remittances between major international cities require form 6 to 12 hours. Obviously, the progress made in the domain of IT has increasingly speed up the accomplishment of these operations, even though, it should be born in mind that the *hawala* system is still based on trust, and as such modern technologies are not deemed to be a prerequisite[149].

As to the cost, typically, remittances arranged through *hawala* are less expensive than through formal banking channels, due above all to the «limited overheads and the virtual lack of regulation and taxation»[150]. In general, intermediaries receive a compensation by charging an initial fee for the transaction or through an exchange rate spread.

Another feature that makes informal *hawala* transfers particularly interesting especially to migrants and expatriated workers pertains to its lack of cultural and language barriers: since such system is managed by community members and relies, at least in principle, on solidarity and trust, it meets migrants' needs, facilitating their remittances without the need to recourse to foreign, and, at times, "alien" banking practices in the "working" Country, while suiting also the customary practices of the Country of origin (e.g. wives who receive money from their expatriated husbands and who live in rural areas of many Muslim States usually do not have contacts with banks or other institutions, therefore such an informal, though trusted service is preferred).

[147] *Id.* The abovementioned *hawala* transfer is mainly used by expatriate workers who aim to arrange remittances to their families in their home Country. *Id.*, 16 s.

[148] For an overview of migrant labour remittances in South Asian Countries, see MUNZELE - ADAMS JR. – PASSAS -AGGARWAL, *Migrant Labour Remmittances in South Asia*, 2005. *Available at SSRN*: http://ssrn.com/abstract=873930

[149] EL QORCHI - MUNZELE MAIMBO - WILSON, *Informal Funds Transfer Systems, An Analysis of the Informal Hawala System*.

[150] *Id.*, 18.

As to the versatility of the system, *hawala* transactions are deemed to be «highly adaptable» to difficult situations, such as «wars, civil unrest, conflicts, economic crisis, weak or non-existing banking systems, as well as economic sanctions and blockades»[151].

The last characteristic, *i.e.* the anonymity of the system, constitutes at the same time both an advantage and a potential threat. In general, «there are neither any standard documentary requirements nor accounting methods for conducting business», moreover, if the documentation actually exists, third parties cannot access it and even if they could, the only information available on the transaction would be the code which is transmitted to the recipient of the remittance in order to prove that he/she is the intended beneficiary of the transfer. So, commonly, no identification document of the remitter is required[152]; as a consequence, given the lack of both documentation and supervision, it is evident that such a system may be exploited also to reach illicit purposes[153].

It might be argued that, as a rule, there are three legitimate uses of the informal *hawala* system, that is: (i) migrant workers remittance, (ii) humanitarian, emergency, and relief aid in conflict-torn Countries[154], and (iii) personal investments and expenditures[155].

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[151] *Id.* Just to mention an example, in Afghanistan, owing to the long-lasting conflict, banks do not accept deposits neither do they extend loans, therefore, the only viable means to arrange remittances and in general to transfer funds is through the informal *hawala* system. *Id.*, at 19.

[152] *Id.*

[153] For instance, circumventing capital and exchange controls, tax evasion, smuggling, money laundering and even financing terrorism. *Id.*, at 22-23. For an analysis of the informal funds transfer systems, among which *hawala* transactions, and the difficulties encountered in implementing regulatory actions so as to prevent 'transnational misconducts', see PASSAS, *Informal Value Transfer Systems, Terrorism and Money Laundering*, Report to the National Institute of Justice. Boston: Northeastern University, 14 November 2003, *Available at SSRN:* http://ssrn.com/abstract=1327839, or at http://dx.doi.org/10.2139/ssrn.1327839, and ANAND AJAY, *The International Regulation of Informal Value Transfer Systems*, *available at SSRN*: http://ssrn.com/abstract=1083689.

[154] For an example of the use of the informal fund transfer systems in war-torn areas, see the following article on the Somali money transfer system, LINDLEY, *Between 'Dirty Money' and 'Development Capital': Somali Money Transfer Infrastructure Under Global Scrutiny*, African Affairs, Vol. 108, Issue 433, October 2009. *Available at* SSRN: http://ssrn.com/abstract=1475090 or http://dx.doi.org/adp046.

[155] EL QORCHI -MUNZELE MAIMBO -WILSON, *Informal Funds Transfer Systems, An Analysis of the Informal Hawala System*, 22.

4.2. *Suftaja*

As opposed to the several requirements laid down by Muslim jurists in relation to *hawala*, very few specifications have been set in respect of the validity of the other traditional instrument of credit, namely, *suftaja*, or "letter of credit".

Suftaja is defined as a currency loan to be repaid by the borrower (banker, or in all likelihood, his associate) in a different place. Its purpose is to avoid the risks of transport. *Suftaja* can be paid to either the original lender (who would then have carried the note with him), or to a third party (to which the *suftaja* would have to be sent).

Hanafi law disapproves *suftaja*, for «the abomination [...] is founded on the loan being attended with profit, in as much as it exempts the lender from the danger of the road; and the prophet has prohibited our acquiring profit upon a loan». It is noteworthy, though, that *suftaja* is disapproved but not forbidden by Hanafis, as long as the parties do not benefit from it[156]; whereas, in case the lender only benefits from said loan, *suftaja* is prohibited[157].

5. Islamic Cards

The present overview on Islamic systems of payment cannot omit one of the most important financial tools in modern economies: credit cards.

Generally, a credit card constitutes a system of payment which allows the cardholder to immediately pay for goods and services, make cash advances, etc., and repay the amounts "borrowed" at a later stage. In practice, the card issuer creates a revolving account and grants a line of credit to the consumer (or cardholder) from which the latter can borrow the money he needs. It follows that purchases made through conventional credit cards may involve the charging of interest. Typically, conventional credit cards are subjected to a grace period of roughly one month, within which the customer is required to

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[156] RAY, *The Medieval Islamic System Of Credit And Banking: Legal And Historical Considerations*, 64. Under Shari'ah, each human act can be placed in one of the following five categories: (1) *wdgib* (obligation); (2) *mandfib* (recommended); (3) *mubah* (permitted); (4) *makrih* (disapproved/disliked); and (5) *haram* (forbidden/prohibited). (NADAR, *Islamic Finance and Dispute Resolution: Part 1,* in *Arab Law Quarterly,* 2009, 23). By relying on this classification, Muslims can assess their behaviours.

[157] RAY, *The Medieval Islamic System Of Credit And Banking: Legal And Historical Considerations*, 63.

'return' the amount borrowed. This means that if the card issuer cannot recover the entire amount lent within the due date, interest charges will be applied to the cardholder.

Given the structure of conventional credit cards, Muslims can, at least theoretically, use them without violating the *riba* prohibition as long as they are able to pay the card issuer within the grace period, so as to avoid any interest payments.

Nonetheless, this opinion is not unanimously agreed upon by Islamic jurists. As a result, Islamic alternatives to conventional credit cards have been developed by many financial institutions, and though their characteristics may vary, they mostly converge on one aspect: that is, providing credit for longer and fixed periods, usually 12 months, and allowing for a decrease in the price to be paid in case of early payments[158].

Yet, many Islamic credit cards issued by Islamic financial institutions seem to mirror the structure of conventional ones, except for the fact that «profit is not compounded»[159].

Taking into account, for instance, the functioning of the Bank Islam Card: the institution sells a piece of land to the customer, and soon thereafter the former purchases the same piece of land at a lower price. The proceeds of the second transaction are paid out into an account from which the customer can withdraw cash and purchase the goods with the credit card. The bank carries out in so doing a *bai inah*, which is a controversial financing method under Shari'a. Moreover, under such a transaction, the bank's profits derive not only from the difference between the purchase and sale prices of the piece of land, but also from fees and profit charges, which partly depend on the repayment period, and which therefore appear to replicate the interest charges of conventional credit cards.

In the light of the importance, and complexity, of these instruments, the AAOIFI, among other institutions, has formulated an *ad hoc* Standard[160], setting a number of provisions regulating the issuance and use of credit cards, debit cards and charge cards.

Let us examine them one by one.

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[158] VISSER, *Islamic Finance Principles and Practice*, 66.

[159] *Id.*

[160] AAOIFI Standard No 2 «is applicable to debit cards, charge cards and credit cards that are issued by institutions to their customers to enable the latter, by using the cards, either to withdraw cash from their accounts or to obtain credit or to pay for goods or services purchased.» AAOIFI Shari'a Standard No 2 on Debit card, Charge Card and Credit Card.

a. **Debit Cards.** The issuance of debit cards does not incur any Islamic law prohibition, since no taking or charging of interest is involved in the use of these cards[161].

This type of card is issued «to a customer with available funds in his account» and, more importantly, «the card confers on its holder the right to withdraw cash from his account or to pay for goods or services purchased up to the limit of the available funds (credit balance) on his account. The debit to the customer's account will be immediate»[162], it follows that debit cards do not provide customers with any credit.

Moreover, «the customer will not normally pay any charges for using this card, except when it is used to withdraw cash or to purchase another currency through another institution different from the institution that has issued the card», however «some institutions charge the party accepting payment by means of the card a commission calculated as a percentage of such payments»[163].

As to the restrictions concerning to type of cards, the AAOIFI Standard sets, that «it is permissible for institutions to issue debit cards, as long as the cardholder does not exceed the balance available on his account and no interest charge arises out of the transaction»[164].

b. **Charge Cards.** Charge cards are defined as cards providing «a credit facility up to certain ceiling for a specified period of time, as well as providing a means of repayment»[165]. Similar to debit cards, the issuance of charge cards is deemed licit because it does not violate any Shari'a prohibition, and, in addition, because the contract underlying a charge card does not involve the charging of interest in exchange for granting a credit facility[166].

As a matter of fact, the Standard sets that «this card does not provide revolving credit facilities to the cardholder insofar as the cardholder is obliged to make payment for the purchased goods or services by the hand of a prescribed credit period following receipt of a statement sent by the institution issuing the card»[167].

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[161] AAOIFI Shari'a Standard No 2 - Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[162] AAOIFI Shari'a Standard No 2, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[163] *Id.*

[164] *Id.*

[165] *Id.*

[166] AAOIFI Shari'a Standard No 2, Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[167] AAOIFI Shari'a Standard No 2, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

While, the institution that issues the card does not charge the cardholder any percentage commissions on his purchases, although it receives a percentage commission from the party accepting the card on the purchases made by using such card.

Furthermore, the issuer «has a personal and direct right against the cardholder to be reimbursed for any payments made on his behalf»[168].

Concerning the issuance of charge cards, the Standard establishes two main conditions that must be met « a) The cardholder is not obliged to pay interest in the case of delay in paying the amount due.

b) The institution must stipulate that the cardholder may not use the card for purposes prohibited by the Shari'a and that the institution has the right to withdraw the card in case such a condition violated»[169].

c. **Credit Cards.** It is apparent that among the three types of cards, credit cards represent the instrument which is subjected to greater restrictions, due to the fact that its permissibility depends precisely on the observance of the ban on *riba*. If the contract between the card issuer and the cardholder involves either the charging or taking of interest, the credit card breaches the Shari'a rules and its issuance is therefore forbidden. Hence, only credit cards that do not incur *riba*, or any other legal prohibition, are permissible[170].

The relevant Shari'a Standard of the AAOIFI sets in this regard, that «it is not permissible for an institution to issue credit cards that provide an interest-bearing revolving credit facility, whereby the cardholder pays interest for being allowed to pay the debt in installments»[171].

Specifically, credit cards provide «a revolving credit facility within the credit limit and the credit period determined by the issuer of the card», while being also a means of payment[172]. In particular, «when purchasing goods or services, the cardholder is given a free credit period during which the amount due should be paid and no interest is chargeable. The cardholder is also allowed to defer paying the amount due and is charged interest for the duration of the credit. In the case of a cash withdrawal, there is no free credit period»[173].

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[168] *Id.*

[169] *Id.*

[170] AAOIFI Shari'a Standard No 2 - Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[171] *Id.*

[172] AAOIFI Shari'a Standard No 2, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[173] *Id.*

The institution which issues the card does not charge any percentage commission on purchases from the cardholder, though being entitled to be reimbursed for each payment made on the behalf of the latter[174].

Moreover, a precise restraint is laid down in case of gold, silver and currencies purchases, namely, «it is permissible to purchase gold, silver or currency with a debit or a charge card, in cases where the issuing institution is able to settle the amount due to the party accepting the card without any delay»[175]. This operation is considered licit because «purchasing with a debit card constitutes constructive possession, as ruled by the International Islamic Fiqh Academy»[176], and therefore it satisfies the legal condition of taking possession governing currencies exchanges[177].

All these rulings rest on the same rationale: the compliance with Shari'a principles. Thus, provided that Islamic law tenets are not violated, and that the instruments meet the conditions set in the Standard, Islamic cards can actually offer services similar to those supplied by conventional cards.

In particular, the institution issuing the card can «charge a commission to the party accepting the card, at a percentage of the purchase price of items and services purchased using the card»[178], because this operation is regarded as a form of brokerage and marketing fee, on the one hand, and, «as a service charge for the collection of the debt»[179], on the other hand; both of which are deemed to be, to some extent, lawful under Shari'a.

Furthermore, «it is permissible for the institution issuing the card to charge the cardholder membership fees, renewal fees and replacement fess.»[180] The basis for its permissibility lies in the fact that the institution grants the cardholder the right to use the card and benefit from its services[181].

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[174] *Id.*

[175] *Id.*

[176] Resolution No 53 (4/6).

[177] AAOIFI Standard No 2 - Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[178] AAOIFI Standard 2, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[179] AAOIFI Standard 2- Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[180] AAOIFI Standard 2, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[181] AAOIFI Standard 2- Appendix B, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

Besides, concerning cash withdrawals, the Standard allows «the institution issuing the card to charge a flat service fee for cash withdrawal, proportionate to the service offered, but not a fee that varies with the amount withdrawn»[182], for interest cannot be paid on such amounts.

It follows that, though the charging and taking of interest are forbidden, Islamic institutions may however receive nearly the same mark-up charged by conventional banks by disguising it as a lawful service fee.

6. Conclusions

At first sight, the Islamic system appears to be at odds with the European (Western) one.

Differences actually exist, it is a fact. The two systems have evolved out of two diverse legal and cultural traditions: while the Western world displays a more "deregulated" approach to economic and financial issues, the Muslim pattern is characterized by binding proscriptions.

As a matter of fact, five strict basic rules govern financial transactions under Islamic law, namely, (i) the prohibition of *riba*, (ii) the prohibition of *gharar* and *maysir*, (iii) the acknowledgement that money is not a commodity and its value does not change as time passes by, (iv) the prohibition of specific industries, which are considered *haram* under Shari'a, though being fully permissible in conventional systems (e.g. trading in alcohol or pork meat products, or gambling), and (v) the prohibition to connect sale contracts. Alongside the aforementioned restrictions, the Islamic Banking and Finance is also strongly characterized by the need for asset-backed operations (which permit to prevent the involvement of *riba* transactions) and the recourse to profit-loss-sharing schemes, which embody the Muslim idea of moral economy.

So, the question essentially is: could we reconcile these two different approaches to economics and finance? And if so, how?

Here are some suggestions which may be taken into account in order to implement a single EU payment system that is tailored also to the needs of European Muslims. In this regard, it is worth adding that not only do Muslims represent a substantial share of European population[183] but, at the same time,

[182] AAOIFI Standard No 2, AAOIFI Shari'a Standards for Islamic Financial Institutions, 2010.

[183] According to the study conducted by the Pew Research Center (Mapping the Global Muslim Population: A Report on the Size and Distribution of the World's Muslim Population), in 2009 the number of Muslims in Europe amounted to nearly 38 million, namely, 5% of its

they may constitute prospective customers of local financial institutions. The majority of them, is, in fact, forced to use conventional systems of payment for no alternative solutions are presently available in most European Countries, which in many cases amount to practices in violation of the Shari'a principles[184].

So, in order to settle this issue, it is necessary to act on a three-fold level:

- (i) even though the practice of the Islamic banking and finance is restricted by the existence of the aforementioned bans and forbidden activities, the Western free market shall not regard them as insuperable obstacles. As a matter of fact, similar "moral" barriers have not prevented the successful development of ethical banking in the West. Therefore, this first barrier represents only an obstacle on the level of the rules of principles.
- As to the deficiencies of the Western pattern to theoretically implement a system that would suits also Muslims' needs, this problem may be sorted out by fostering the study of Islamic finance among non-Muslims so that to extend the participation to Shari'a boards also to Western experts. In so doing, not only may the awareness of IBF functioning be enhanced, but at the same time both parties (*i.e.* Muslims and non-Muslims) would be involved in and contribute to the creation of an operative 'integrated' EU payment system.
- Lastly, the concrete operational rules of the two systems are less different than it may seem at first glance; hence, once the main theoretical concerns have been overcome, practical endeavors may be undertaken, starting from a broad "customization" of financial instruments issued by European banks and institutions. In other words, EU banks and financial institutions could develop a parallel set of Shari'a-compliant devices, by relying on both legal and financial standards largely shared by the international Muslim community and the support of field experts. Specifically, attempts shall be made in order to: (i) draw up model contracts that could be employed in case of transactions with Muslim clients, (ii) implement *Shari'a*-compliant current accounts and investment options (namely, Muslims would be granted the possibility to choose according to their "risk tolerance", such as "conventional"

entire population. *Available at* http://www.pewforum.org/2009/10/07/mapping-the-global-muslim-population/ (last visited 10 September 2014).

[184] The Islamic Law or Shari'a can be defined as an all-encompassing ethics, a sort of code of conduct which governs all aspects of Muslims' life, trading activities included, and which must be abided by so as to conduct a virtuous life. Hence, no clear-cut separation between religious and secular matters exist under Shari'a, therefore any breach of the precepts laid down in the Qur'an and in the Sunna (the two primary sources of Islamic law) accounts for a departure from the "righteous path". See: LEWIS - ALGAOUD, *Islamic Banking*, 25.

customers do) and (iii) create a body composed by renowned Islamic Law experts that would carry out the same functions of a *Sharia* supervisory board.

In so doing, not only would the needs of part of the European population be met, but the way towards an actual implementation of an all-round payment system would actually be paved. In addition, a twofold purpose would be served as well. European banks could give rise to a new market that might foster the recovery of the whole economic system, while, Muslims would be granted rights and protections deriving from EU consumer law, though acting in accordance with the *Shari'a*.

It follows, that, by bearing in mind common objectives, differences can partly be bridged, while acknowledging the importance of a tradeoff between Muslims' needs and European financial and banking system would definitely favour the whole European society.

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REGULATING DIGITAL PAYMENT SYSTEMS THROUGH A FINANCIAL GOVERNANCE PARADIGM

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Every time we hear or read about the collapse of Lehman Brothers and the crisis that resulted from it, we relate it immediately to the term "shadow banking"; however, one aspect of the shadow banking system that has not been analysed under this figure is the proliferation of financial governance paradigms that have been materialized through peer-to-peer projects such as lending facilitators/platforms and digital media of exchange; projects structured around the ideas of Friedrich Hayek and the Austrian School of Economics.
Despite the good intentions of these initiatives, good governance is needed to secure three core elements: 1) security of property rights; 2) enforcement of contracts; and 3) collective action. Although the term "governance" is relatively new, the sovereign intervention in private initiatives has a rather long history; for example, throughout this history, the issuance of private money has been subject to taxes and the seignorage.
In the European context, entities carrying out banking-type activities, but which were lightly regulated, were at the centre of crises such as the Gebroeders de Neufville Crisis of 1763 and the Overend, Gurney & Co. panic of 1866. In particular, the latter, was the origin of a new concept: the lender of last resort proposed by Walter Bagehot. Therefore, through an optimal financial governance paradigm we could control the interaction betwixt legislators and financial innovators; thus, allowing us to regulate and integrate some of these innovations to our payment systems.

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Social inventions are no less important than advances in technology. Developing new tools or weapons is one road to greater prosperity; another is the construction of new rules, customs and behaviours.
Gunnar Wetterberg (2009)

1. Introduction

Money and payment systems have evolved over time. Historically, the "financialization" of the world as described by Polanyi-Levitt[1] has put some challenges on traditional regulatory paradigms; particularly, by those related with payment schemes that individuals periodically structure around free banking models as response to different inducements such as financial crises. This "financialization" has been structured around money and the payment systems related to it, which have evolved according to the oddities of their respective contexts. In absence of an act of legislation, the first payment systems were regulated by merchants, (generally by those merchants that practiced long-distance trade and that were, consequently, exposed to a great variety of media of exchange). Thus, they set the value of the set commodities used as money, divided money into "special purpose" and "all purpose" money under the anthropological premises of Karl Polanyi[2] and Viviana Zelizer[3], and sanctioned the bad practices related to its use. The sovereign intervention into the process of financial innovation came at a much later stage, after some financial instruments had already emerged and evolved through the minds of some creative individuals that, in the case of some financial innovations, have even left us a signature (i.e. Satoshi Nakamoto). Despite money and financial instruments in general were not a sovereign creation, they have been perfected and adapted to the diverse and changing needs of developing trade through government recognition and regulation[4].

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[1] POLANYI- LEVITT, *From the Great Transformation to the Great Financialization. On Karl Polanyi and Other Essays,* 2013, New York.

[2] POLANYI, *The Great Transformation,* 1989, Madrid.

[3] ZELIZER, *The Social Meaning of Money: Special Monies,* in the *American Journal of Sociology, 1989,* 95(2), 342-377.

[4] MENGER, *On the Origin of Money,* in *the Economic Journal,* 1892, 2(6), 239-255; SCHLICHTER, *Paper Money Collapse. The Folly of Elastic Money and the Coming Monetary Breakdown,* 2012, New Jersey; SEMENOVA, *The Origins of Money: Evaluating Chartalist and Metallist Theories in the Context of Ancient Greece and Mesopotamia,* Thesis presented in partial fulfilment of the requirement for the degree Doctor of Philosophy, University of Missouri, Kansas City.

In contexts of crisis, individuals introduce to the system alternative payment paradigms that: 1) brake the indirect model of financial intermediation and/or 2) create a new scheme of intermediation outside the regulatory framework put in place by every Nation in that particular context that, as we will see later, constitute the core of the definition of "shadow banking"[5]; which in turn, constitute the perfect representation of the interaction amongst the State, the civil society and the market, elements that configure the definition of "governance".

The terms of "governance" and "shadow banking" have risen from obscurity to buzzwords status in our context post-Lehman Brothers, and as with any buzzword, everyone understands these terms a little differently. In the particular case of the former, most people's first instinctive reaction to the recognition of the relevance of governance paradigms is that good governance should be provided by the government[6]. However, there are other social institutions of governance that function in niches that the government serves poorly, or not at all, and because sometimes they work better than the formal law they introduce inducements for unregulated innovation.

2. "Shadow Banking"

The history of "shadow banking" is one of shifts in the type of institutions involved in it, but there is a common element across the decades. "Shadow banking" has caused or been at the heart of several financial crises in different periods and one important factor behind its growth has been the style and extent of bank regulation[7]. For example, during the eighteenth and nineteenth century, "shadowy" innovations relating to legal-financial fictions such as the bill of exchange unleashed two financial crises that, considering their particular elements, are compared with the Lehman Brothers collapse: the *Geboreders de Neufville* crisis of 1763 and the *Overend, Gurney & Co.* panic of 1866[8].

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[5] Indirect finance is materialized through constitution of financial intermediaries that mediate betwixt the primary borrower and primary lender of funds in contrast with direct finance by means of which a borrower and a lender meet directly.

[6] DIXIT, *Governance Institutions and Economic Activity,* in *The American Economic Review,* 99(1), 6.

[7] JACKSON, *Shadow Banking and New Lending Channels-Past and Future,* in BALLING-GNAN (eds), *50 Years of Money and Finance: Lessons and Challenges,* 2013, 377.

[8] CEDILLO, *The Historical Role of the European Shadow Banking System in the Development and Evolution of Our Monetary Institutions,* in *CITYPERC Working Paper Series*, 2013, 5, 7.

2.1. Defining “Shadow Banking” through “Governance”

Amongst academics, governance refers to a “new” process of governing; however, this is not so simple. If we look for a definition of the term “governance”, we will find that it is used in different contexts and it is distinguished amongst governance in public administration, governance in international relations, European Union governance, corporative governance, and governance as extolled by institutions such as the World Bank. Unfortunately for us, these uses have little or nothing in common; thus, for our purposes, we can define governance with basis on the following elements[9]:

1) Interdependence betwixt sovereign and non-sovereign actors.

2) Continuing interactions amongst networks members, as result of the necessity to exchange resources and negotiate shared purposes.

3) Game-like interactions, rooted in trust and regulated by rules of the game negotiated and agreed by network participants.

4) A significant degree of autonomy from the State.

In sum, governance refers to governing with and trough public-private networks by means of which the State, the market and the civil society provide public goods such as monetary and financial stability. The absence of these interactions results in negative outcomes such as financial crises.

As with many debated topics such as “governance”, the source of confusion in “shadow banking” begins with its definition. Despite the fact that historically we found similar terms relating to “shadow banking” such as “pseudo-banking” institutions, which was proposed by Hammond Chubb[10] in 1872, the term “shadow banking” is relatively new in our academic literature. Its creation has been attributed to the economist and money manager Paul McCulley who, in 2007, described under the referred term «a large segment of financial intermediation that is routed outside the balance sheets of regulated commercial banks and other depositary institutions»[11]. Since then, a myriad of authors and institutions have proposed their own definitions which include common elements like trading activities of hedge funds, sovereign

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[9] RHODES, *Understanding Governance: Ten Years On,* in *Organization Studies*, 2007, 28, 1246.

[10] CHUBB, *The Bank Act and the Crisis of 1866,* in the *Journal of Statistical Society of London,* 1872, 35(2), 171-195.

[11] MCCULLEY, *Teton Reflections,* in *PIMCO Global Central Banks Focus*, 2007, August/September, 1-4.

guarantees, and traditional financial practices like credit intermediation[12]. Therefore, we found definitions such as the following:

- **Edward J. Kane[13]**: «A shadow bank is an institution or bank-sponsored special purpose vehicle that has persuaded its costumers that its liabilities can be redeemed de facto at par without delay even though they are not formally protected by government guarantees»
- **Klára Bakk-Simmon, et al.[14]**: «shadow banking is the set of 'activities related to credit intermediation, liquidity and maturity transformation that take place outside the regulated banking system'».
- **Financial Stability Board[15]**: «The 'shadow baking system' can broadly be described as credit intermediation involving entities and activities outside the regular banking system».
- **Lord Adair Turner[16]**: «Shadow banks are institutions or chains of institutions that get involved in two particular bank-like activities; either they create credit, such as by using the same assets multiple times, or they engage in maturity transformation».
- **Zoltan Pozsar, et al.[17]**: «Shadow banks are financial intermediaries that conduct maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees».

But "shadow banking" is almost certainly broader than this[18]. The Institute of International Finance[19] accurately sees "shadow banking" in relation to three core activities of banks: 1) taking highly liquid deposits, 2) extending

[12] CEDILLO, *The Historical Role of the European Shadow Banking System in the Development and Evolution of Our Monetary Institutions,* in *CITYPERC Working Paper Series*, 2013, 5, 2.

[13] KANE, *The Inevitability of Shadow Banking,* Presentation for the Financial Conference at the Federal Reserve Bank of Atlanta., Georgia, 2012, 2.

[14] BAKK-SIMON et al, *Shadow Banking in the Euro Area,* in *ECB Occasional Paper Series,* 2012, 133, 8.

[15] FSB, *Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the FSB,* 2011, 1.

[16] MASTERS, *Regulators peer into financial shadows,* in *Financial Times,* 2012, http://www.ft.com/intl/cms/s/0/36878ee2-3175-11e2-b68b-00144feabdc0.html#axzz2IKhRcygB

[17] POZSAR et al., *Shadow Banking,* in *Federal Reserve Bank of New York Staff Reports,* 2010, 458, 6.

[18] JACKSON, *Shadow Banking and New Lending Channels-Past and Future,* in BALLING-GNAN (eds), *50 Years of Money and Finance: Lessons and Challenges,* 2013, 377.

[19] IIF, "*Shadow Banking": A Forward Looking Framework for Effective Policy,* 2013, Washington, D.C., 4.

credit, and 3) providing a payments system; which have been driven outside the traditional system by light or non-existent regulations. So, with the aim of contributing to a better understanding of this term, I define "shadow banking" as the set of financial institutions, activities, markets and contracts that result from the evolution of practices and traditions of private individuals and/or institutions, outside the regulatory framework put in place by every Nation in a particular context to regulate their respective financial sectors.

2.2. Where are we going? and how do we get there?

Particularly, the past five decades have seen a destabilization of the traditional governing mechanisms and have been characterized by liberalisation and deregulation under new arrangements of governance. Consequently, people and institutions have been allowed more and more to define and follow their own goals outside traditional regulatory paradigms[20], despite the fact that some sectors such as banking have always tended to be regulated more than other areas of the economy because of its inherent "dangerous" systemic nature, which has been recognized for long[21]. So, one question is what lies ahead?

Historically, the State manage innovations to some degree by coming in to support the private media of exchange and/or payment systems through their gradual nationalization. An illustration of this is the Medici banking house, which made its financial mark through the *banchi grossi*[22] model by dealing merchandise and facilitating money transfers for merchants and traders across renaissance Europe[23]. The system the Medici developed exploited

[20] BERNANKE, *The Effects of the Great Recession on Central Bank Doctrine and Practice,* Speech at the Federal Reserve Bank of Boston 56th Conference, 2011, Boston; BALLING-GNAN, *Shadow Banking in the Euro Area,* in *ECB Occasional Paper Series,* 133; WEISS, *Governance, Good Governance and Global Governance: Conceptual and Actual Challenges,* in *Third World Quarterly,* 2009, 21(5).

[21] BALLING-GNARR, *Shadow Banking in the Euro Area,* in *ECB Occasional Paper Series,* 133.

[22] In Florence, in the fifteenth century, there were four different credit intermediaries called banks in Italy: *banchi di pegno, banchi a minute, banchi in mercato,* and *banchi grossi*. DE ROOVER, The Medici Bank Organization and Management, in *The Journal of Economic History*, 1946, 6 (1), 24-52.

[23] DE ROOVER, *The Medici Bank Organization and Management,* in *The Journal of Economic History,* 1946, 6(1), 24-52; KAMINSKA, *The theory of money entanglement (Part 2),* in *Financial Times,* 2013, http://ftalphaville.ft.com/2013/12/19/1728302/the-theory-of-money-entanglement-part-2/

the fact that it was not only extremely cumbersome and dangerous for traders to carry heavy coinage with them to foreign lands, but also incredible expensive to convert such currencies into local equivalents because of foreign money bans or capital controls[24]. However, through the Medici system a *prenditore* could deposit his collateral at home, be issued a Medici bill of exchange, then pay for the goods at the destination point via the liquidation of the referred bill at the prevailing local currency rate with basis on gold florin[25]. This, of course, is not dissimilar to how digital media of exchange operate: Medici bills became money-like in their own right, bestowing the Medici with the awesome power of *seignorage.* However, the Medici's ability to exploit that power in the modern free banking sense was constrained by usury laws of the day. Thus, much of it was directed at lending to governments[26].

Now, despite that the Medici case is a very old example, for Europe, this is a familiar scenario. European merchants, money changers and bankers have introduced unregulated financial innovations, such as Lydian coins, which were gradually regulated and adopted by European institutions. These financial developments have evolved progressively and, paradoxically, they constitute the fulcrum of our Financial World System; thus, we can affirm that financial innovation periodically change the legal framework within which financial markets in Europe, and that the current innovations will force us to adapt regulatory frameworks around the world to include innovations such as Peer-to-Peer lending and digital media of exchange in our regulated payment systems.

3. Peer to Peer Lending

Media around the world tell us when the economy goes into recession that it is necessary to "restore confidence[27]. Confidence plays an important role in understanding economic growth, financial development, low stock market

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[24] COOPER, *The Origin of Financial Crises. Central Banks, Credit Bubbles, and the Efficient Market Fallacy,* 2008, New York; KAMINSKA, *The theory of money entanglement (Part 2),* in *Financial Times,* 2013, http://ftalphaville.ft.com/2013/12/19/1728302/the-theory-of-money-entanglement-part-2/

[25] DE ROOVER, *The Decline of the Medici Bank,* in *The Journal of Economic History,* 1947, 7(1), 69-82; KAMINSKA, *The theory of money entanglement (Part 2),* in *Financial Times,* 2013, http://ftalphaville.ft.com/2013/12/19/1728302/the-theory-of-money-entanglement-part-2/

[26] KAMINSKA, *The theory of money entanglement (Part 2),* in *Financial Times,* 2013, http://ftalphaville.ft.com/2013/12/19/1728302/the-theory-of-money-entanglement-part-2/

[27] AKERLOR-SHILLER, *Animal Spirits. How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism,* 2009, New Jersey.

participation, diversification on investors' financial portfolios, as well as the pattern of cross-border investments[28]; confidence, in theory, is rational: people use the information at hand to make rational predictions[29]. Consequently, information asymmetry betwixt financial institutions and borrowers is one of the key issues in the financial sector[30].

Banks are the materialization of a good governance paradigm because they are designed as delegated monitors. Authors such as Xavier Freixas and Jean-Charles Rochet[31] argue that banks exist because ensuring the enforcement of contracts is costly; hence, intermediaries are established to economize on the actions required to achieve that social goal. However, following the financial crisis, the bank's retrenchment has given a boost to small-scale operators such as loan sharks, pay day lenders, pawnbrokers amongst others. According to the Economist[32], the value of payday loans in Britain more than doubled betwixt 2010 and 2012, to almost £800m. More importantly, these shadowy institutions have encouraged a new form of grass-roots finance: peer-to-peer lending[33].

Peer-to-peer lending is the practice of direct unsecured lending to small businesses or individuals by other individuals and potentially other businesses, but in terms of quantity is predominantly lending to individuals[34] through some sort of online system[35]. All peer-to-peer lending communities operate on the principle of "full financing" (i.e. the loan request gets funded only if it receives enough bids to cover the entire amount requested by the

[28] DUARTE-SIEGELL-YOUNG, *Trust and Credit,* Electronic Document, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1343275

[29] AKERLOR-SHILLER, *Animal Spirits. How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism,* 2009, New Jersey.

[30] LIN, *Peer-to-Peer Lending: An Empirical Study,* Document accepted for its inclusion in AMCIS Consortium, 2009, San Francisco.

[31] FREIXAS-ROCHET, *Economía Bancaria,* 1997, Madrid, 36-37.

[32] THE ECONOMIST, *Shadow and Substance,* in *The Economist,* 2014, 41(8886).

[33] JACKSON, *Shadow Banking and New Lending Channels-Past and Future,* in BALLING-GNAN, *50 Years of Money and Finance: Lessons and Challenges,* 2013. THE ECONOMIST, *Shadow and Substance,* in *The Economist,* 2014, 41(8886).

[34] JACKSON, *Shadow Banking and New Lending Channels-Past and Future,* in BALLING-GNAN, *50 Years of Money and Finance: Lessons and Challenges,* 2013.

[35] THE ECONOMIST, *Shadow and Substance,* in *The Economist,* 2014, 41(8886).

borrower)[36]. The peer-to-peer firm is only an intermediary and does not underwrite the risk as described by authors such as Mehrling[37], and Freixas and Rochet[38] under the traditional financial intermediation model, but they provide other services such as marketing to attract lenders and borrowers and information gathering and monitoring; depending heavily on whether information production in this context can prove to be no less efficient than what is produced by regulated intermediaries[39]. Some offer insurance against defaults, others pass losses directly to investors[40]. Lenders earn a higher rate of interest than they can get on a bank deposit, and borrowers generally pay less than they would for a loan from a traditional source. The peer-to-peer firm makes money by leaving a fee, usually a small percentage of the money lent[41].

Initially, one could be tempted to think that the regulation of these firms could be relatively easy as result of the regulations relating to Big Data that are appearing around the world, and the regulations on money transmitters that have been put in place trying to face some financial innovations in digital contexts with basis on legal definitions of money. Unfortunately, we have not considered that these firms could, eventually, work with unregulated digital media of exchange; thus, creating systemic risk due to the volatile nature of the latter.

4. Hierarchy of Money

Always and everywhere, monetary systems are hierarchical. Historically, economists around the world try to get an analytical grip on this empirical fact is to distinguish "money" from "credit"[42]; thus, we can start our analysis on the hierarchy of money with basis on the remnants of an old paradigm: barter.

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[36] HERZENSTEIN et al., *The Democratization of Personal Consumer Loans? Determinants of Success in Online Peer-to-Peer Lending Communities,* Electronic Document, 2008, www.rice.edu/nationalmedia/multimedia/online

[37] MEHRLING, *The Inherent Hierarchy of Money,* in *Social fairness and economics: economic essays in the spirit of Duncan Foley,* 394-404.

[38] FREIXAS-ROCHET, *Economía Bancaria,* 1997, Madrid.

[39] JACKSON, *Shadow Banking and New Lending Channels-Past and Future,* in BALLING-GNAN, *50 Years of Money and Finance: Lessons and Challenges,* 2013, 401. LIN, *Peer-to-Peer Lending: An Empirical Study,* Document accepted for its inclusion in AMCIS Consortium, 2009, San Francisco, 3.

[40] THE ECONOMIST, *Shadow and Substance,* in *The Economist,* 2014, 41(8886).

[41] THE ECONOMIST, *Shadow and Substance,* in *The Economist,* 2014, 41(8886).

[42] MEHRLING, *The Inherent Hierarchy of Money,* in *Social fairness and economics: economic essays in the spirit of Duncan Foley,* 394-404.

Long time ago, the first trade was conducted via barter by means of which all goods were exchanged directly for all other goods. However it was not a great system; for example, if you wanted to swap your fish for a loaf of bread, but the baker happened to want firewood, you were stuck with the task of traipsing around the market until you could find someone with firewood who just happened to want fish. Despite its drawbacks societies around the world muddled along with barter exchange for a few hundred thousand years[43]. This problem led to the social invention of money, which gradually was adopted by sovereign entities through regulation.

Sovereign currencies are a form of sovereign credit in the sense that they are promises to pay a certain amount of a particular commodity with basis on a particular legislation. In theory, if we take a metallic standard as our basic paradigm, a currency may be backed mostly by silver and/or gold, in the sense that the issuer of the currency holds some silver and/or gold in its vaults. Further down the hierarchy, bank deposits are promises to pay currency on demand, so they are twice removed promises to pay the ultimate money, and securities are promises to pay currency over some time horizon in the future, so they are even more attenuated promises to pay[44].

Despite the sovereign intervention in the evolution of money, in contexts of crisis, individuals introduce to the system alternative media of exchange based on some cultural elements, in our particular case, elements relating to the context of the information society.

4.1. Digital Media of Exchange

If we analyse the historical evolution of money, we can appreciate its progressive dematerialization. As electronic payments get easier, notes and coins make up only a tiny part of the money in circulation: just 3% in Britain, for example[45]. At the end of this dematerialization process, money takes the form of information flows through computer networks either at a bank or at the central bank[46]. The science of cryptography, which is the science of keeping

[43] COOPER, *The Origin of Financial Crises. Central Banks, Credit Bubbles, and the Efficient Market Fallacy,* 2008, New York.

[44] MEHRLING, *The Inherent Hierarchy of Money,* in *Social fairness and economics: economic essays in the spirit of Duncan Foley,* 394-404.

[45] THE ECONOMIST, *Leaving Dead Presidents in Peace,* in *The Economist,* 2014, 41(8905).

[46] RADAVANOVIC, *Digital Economy, Digital Money and Digital Money,* in *Economics and Organization,* 2009. 6(2), 153-160; THE ECONOMIST, *Leaving Dead Presidents in Peace,* in *The Economist,* 2014, 41(8905).

digital data secure, makes this possible[47]. With basis on this, we can define digital media of exchange as unregulated online accounts that measure and record transactions of financial value amongst nodes through the Internet which are designed and controlled by their developers[48]. The first ones boomed on the strength of gaming systems, but now these innovations are moving out of virtual gaming systems into the global economy. These media of exchange had begun in the public-interested spirit of open source P2P software and libertarian political philosophy, with references to the work of Friedrich Hayek and the Austrian School of Economics[49].

4.1.2. "Digital Currencies". An abuse of language

If we write the word "currency" in the web search engine of our preference, immediately we will find many results relating to "virtual currencies", "digital coins", and financial innovations such as Bitcoins, Litecoins, Facebook credits, and Vens, amongst others. As we can see, practically all aspects that integrate the monetary theory can now be represented, scrutinized, processed, digitized and recorded, circulating amongst the information society in the form of binary digits and algorithms; thus, our context turns the task of distinguishing the Metallist-legal concept of "currency" and the generic "money" under a Chartalist approach. In strict legal terms, we use the term "currency" only to define a sovereign medium of exchange recognized by every Nation through their respective monetary legislations. If we analyse these latter, most of them do not integrate in their content, the innovations that constitute private money. For example, according to the article 105a (2) of the Treaty establishing the European Community, the single currency is materialized through coins and bank notes issued with the authorization of the European Central Bank (ECB), and these pieces of metal and paper, as established in their respective regulations, have the status of legal tender within the Community.

In our Financial World System, the lack of a uniform definition adjusted to the spirit of the context, has fostered a myriad of interpretations on the nature of these innovations, in occasions, in opposition to the content of most

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[47] NAKAMOTO, *Bitcoin a Peer-to-Peer Electronic Cash System,* Electronic Document, 2009, http://bitcoin.org/bitcoin.pdf. KOK, *Singapore Electronic Legal Tender (SELT). A Proposed Concept,* in OECD, *The Future of Money,* 2012, 145-152.

[48] ECB, *Virtual Currency Schemes,* 2012, Frankfurt.

[49] WALLACE, *The Rise and Fall of Bitcoin,* in *Wired Magazine*, 2011, http://www.wired.com/magazine/2011/11/mf_bitcoin/all/1.

monetary legislations in force around the world. In some jurisdictions, these innovations have been classed as money, but if we analyse their respective legal definitions of money, we will appreciate that most of these definitions are restricted to the official media of exchange issued by foreign sovereign entities that interact with local currencies.

This abuse of language is not new. If we study contexts relating to this problem such as the nineteenth century of H.D. Macleod where some enthusiasts tried to include under the term "currency" instruments such as bills of exchange and deposits[50], or our particular context where Matt Clinch[51] of CNBC affirmed erroneously, through the popular interpretation of "currency", that Bitcoin was considered legal tender under the German legislation[52]. Against these misinterpretations, Samuel Jones Loyd, Lord Overstone, stated accurately that these innovations do not constitute a currency because this term contemplates only the precious metals converted into coin under a sovereign act, and the notes that, through a legal fiction denominated incorporation[53], represent a particular amount of coins, constituting the currency of a particular country[54].

Just as Macleod[55] explains, this term has its origin in the foundation of the Common Law that established that the property of money passed along with the honest possession of it in every exchange, and from this institutionalized practice, money was said to be current, and from this exceptional property, the expression arose of the currency of money, and gradually it was a common practice to call the money itself currency. If we work with this original definition, certainly we can use the word currency to describe digital media of exchange under a Chartalist theory of money's origin, considering that the term money is a generic used to describe private innovations and sovereign currencies.

However, there is a difference betwixt the original and the current uses derived from the evolution of law and the legal use of the generic money. As result of this latter, some governmental agencies and economists ignore the

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[50] MACLEOD, *Theory and Practice of Banking,* 1906, London.

[51] CLINCH, *Bitcoin recognized by Germany as 'private money', CNBC,* 2013, http://cnbc.com/id/100971898.

[52] CNBC recognized later that this story incorrectly stated that the virtual "currency" was legal tender, confirming the original criteria that defines this innovation only as "private money".

[53] DAVALOS, *Títulos y operaciones de crédito,* 2005, Mexico City, 85.

[54] MACLEOD, *Theory and Practice of Banking,* 1906, London, 316.

[55] MACLEOD, *Theory and Practice of Banking,* 1906, London, 292.

legal definitions that apply to our context or have not been aware of their existence and use the term "currency" to apply to all media of exchange, including credit instruments and bank credit.

5. Regulation or Governance?

Regulating the innovation and the use of technology is an inherently difficult task. Society has placed a high value on rapid technological advancement. Unfortunately, the concomitant development of the law to account for the effects of new technologies frequently occurs very slowly just as we have recognized in documents such as "Virtual Currency Schemes" issued by the European Central Bank[56]. Consequently, under the same spirit of the Directive 2009/110/EC of the European Parliament and the Council, we have to create flexible, technologically agnostic rules, which in turn will depend critically on clear definitions of "bank" and "currency". For this purpose, we should first achieve, through uniform definitions, a good understanding of the structure and properties of the existent "shadow banking" system. Thus, we could determine whether existing institutions are there for good reason, and how our reforms would interact with these innovations in the short and in the long run, analysing the applicability of the Gresham's law as result of the gradual dematerialization of money, its impact on the *seignorage* of central banks, and its relevance for monetary legislations around the world in order to study the viability of a reform to empower sovereign entities such as central banks to issue and regulate digital currencies.

This task sounds relatively easy, but law and economics involves the study of how people, under a rational paradigm, use and allocate finite resources. However, when the analysis goes beyond a particular culture or era, detecting regular relationships becomes more difficult. Changes in technology, institutions and customs alter the circumstances on which choices are based, sometimes to such an extent that time honoured truths and rules of thumb no longer apply[57].

Consequently, for our purposes, we have to accept that "governance" is important because markets, and financial transactions, more generally, cannot

[56] ECB, *Virtual Currency Schemes,* 2012, Frankfurt

[57] WETTERBERG, *Money and Power. From Stockholms Banco 1656 to Sveriges Riksbank today,* 2009, Stockholm, 11.

function well in its absence. A good governance paradigm is needed to secure three essential prerequisites of market economies[58]:

1) Security of property rights: In its absence, individuals will lack the inducements to save and invest through these innovations, because they will fear that others, such as in the case of Mt. Gox, will deprive them of the fruits of these activities.

2) Enforcement of contracts: Economic transactions promise gains to all voluntary participants, but each party may lose if the other fails to fulfil its promised role in the transaction, but instead acts opportunistically under a free-rider scheme. Fear of such counterparty cheating may prevent people from entering in agreements involving digital media of exchange. Formally, as Dixit affirms, this is a bad equilibrium in a prisoner's dilemma.

3) Collective action: Much private interactions depend on an adequate provision of public goods and the control of public "bads", including not just physical but also institutional and regulatory framework to avoid free-riding.

In our context, public administration and the development of legal frameworks are the subject of several debates betwixt the ordinary citizen and the sovereign institutions. Legislate in the postmodern era means considering ordinary people and the schemes of civil association that foster social manifestations such as the proliferation of peer-to-peer lending platforms and digital media of exchange. Before, legislative and regulatory acts were design to face and satisfy massive and anonym interests, but now our legislators and regulators around the globe are facing challenges that have their origin in the diversity of interests that demand solutions to particular problems.

Considering the structure of the European world-system, if Europe does not adopt its historical pragmatic approach and follows the current regulatory tendencies that do not consider development of peer-to-peer projects, it will put itself in a competitive disadvantage. The European Central Bank has recognized that our current regulatory framework lag behind technological developments by some years, and works with the idea that innovators could be registered as financial institutions with their respective regulatory authorities[59]. Particularly I believe that this point brings a problem of agency to this

[58] DIXIT, *Governance Institutions and Economic Activity,* in *the American Economic Review,* 99(1), 5.

[59] ECB, *Virtual Currency Schemes,* 2012, Frankfurt, 45.

proposal and, again, works with the developments of a particular context. Probably, considering the structure of the European world-system, a more interesting idea on this sense could be the insertion of a common definition of bank in the European legislative instruments that integrates not only the issuance of digital media of exchange, but also the potential of new developments structured around these monetary fictions. This new definition would, gradually, allow us integrate new innovations to the “arsenal” of products and services of the current European institutions. Furthermore, recognizing the fact that a return to a commodity-based monetary standard is unlikely, we may expect that in the future our Financial World System could work around a “digital standard”. Considering this possible scenario, I believe that the European Central Bank has the experience and the institutional framework to regulate the "democratic" projects inspired in the work of Hayek in a context of popular aversion against the financial sector, and take advantage of them taking the regional project to the next level through a digital Euro. This digital project could represent the first step to materialize the spirit of the "*moneta imaginaria*" proposed by Gasparo Scaruffi in 1582; thus, putting the example to the rest of the world who, gradually, could insert itself into a new global paradigm structured around the premises of Immanuel Wallerstein[60].

[60] WALLERSTEIN, *The Modern World-System. Capitalist Agriculture and the European World-Economy in the Sixteenth Century,* 1976, New York.

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REGULATING MOBILE-PAYMENTS. LEARNING FROM THE GLOBAL EXPERIENCE

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Regulatory restrictions and/or regulatory uncertainty are the most formidable barriers to expanding mobile-payments (hereinafter "m-payments") to the mass market. Pioneering regulatory models, Brazil, Kenya, the Philippines and South Africa - where mobile banking is really attractive to unbanked and under-banked people because of the lack of bank branches - provide clues worldwide. The European Union Directive on Payment Services (PSD), introduced in 2007, may also serve as a benchmark. The Directive, which provides the legal foundation for the creation of an EU-wide single market for payments, seeks to improve competition by opening up payment markets to non-banks, thus fostering greater efficiency and cost-reduction. One lesson from the global experience so far is that it is too early for regulators and practitioners to assume that there is an established or 'orthodox' method of regulating m-payments. There is still a need to experiment with different business approaches to learn how each performs in different market circumstances.

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[*] This article does not purport to represent the views or the official policy of the World Bank. The findings, interpretations and conclusions expressed in this paper are entirely those of the author. They do not necessarily represent the views of the World Bank or those of the Executive Directors of the World Bank or the governments they represent.

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1. Introduction

Mobile payments (hereinafter "m-payments") have attracted sustained attention in recent years. Their rise has the potential to generate economic and social benefits, by extending access to financial services and fostering growth in sector liquidity.[1]

M-payments often link players in the banking, wireless communications and retail payments sectors. The provisioning of these payments can go from the extreme of being provided by telecommunications operators without any direct involvement of a bank, through being provided in strict cooperation with the banking sector (at least for clearing and settlement), up to situations where banks outsource such services to a telecommunications operator or even use the operator as nothing more than a communication channel, with the service fully provided by banks.

The level of regulatory tinkering needed for the m-payments market has become the subject of intense debate, in advanced as well as less developed economies. Regulators are feeling pressure to develop strategies that will enable and support innovative models of m-payments and dedicated to pursuing a more open and competitive market environment. At the same time, regulators are charged with developing policies to protect consumers, with particular emphasis on those who are considered financially vulnerable. The tension between the desire to innovate and the need to protect has left many regulators without a clear understanding of the most prudent path to take.

[1] The high potential of m-payments for financial inclusions depends on various factors: 1) the ever growing ubiquity of mobile phones: on a world population of 7 billion, there are 5 billion mobile phones, but only 2 billion people have a bank account; 2) consumers are using their mobile phones to make payments in over 130 deployments with a 100 more planned and several new initiatives announced each week; 3) it is a growing market predicted to increase to 900 million users and USD1 trillion in transaction value by 2015. The volume of payments made through mobile phones is currently the fastest growing of all payment methods. The rapid proliferation of smart phones with the option of installing sophisticated payment applications has fuelled this development. SWIFT, *Mobile payments. Three winning strategies for banks*, White Paper, 2012, 1; SUNIL GUPTA, *The Mobile Banking and Payment Revolution*, in *The European Financial Review*, February – March 2013, 2.

2. M-payments

2.1. Overview

M-payments cover all payments made with a mobile phone.[2] These could be either proximity m-payments or remote m-payments. Proximity m-payments occur at the point-of-sale (hereinafter "POS"), like stores, public transport, parking spaces, where customers use a mobile phone with built-in near field communication (hereinafter "NFC") technology to make a purchase at an NFC-equipped POS terminal. Customers can make proximity m-payments at either manned (e.g., checkout registers) or unmanned (e.g., vending machines) POS.

Remote m-payments do not require NFC technology or a POS terminal. Rather, customers use mobile phones equipped with either short-messaging-service (hereinafter "SMS"), i.e., text messaging, or wireless-application-protocol (WAP) technology to make payments any time, any place to either other individuals or to businesses/merchants.

Technology in m-payments is accelerating: smartphones[3], NFC[4] and biometric identification technologies are growing in use around the world. Consumers are then using their mobile phones to conduct many types of transactions. For example, Starbucks and Target provide mobile gift card applications that customers can load onto their phones to make in-store purchases (these gift cards and coupons are displayed as 2-D bar codes on a phone's screen, which are then scanned at the checkout register); mobile ticketing platforms, like the one currently being used by the Bay Area Rapid Transit system, allows consumers to pay for and validate tickets displayed on their mobile phone; Obopay allows customers to transfer funds directly to one another using a mobile application (similar technology is being used in developing countries to facilitate transfers where few physical banks exist).

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[2] M-payments are payments for which the payment data and the payment instruction are initiated, transmitted or confirmed via a mobile phone or device. This can apply to online or offline purchases of services, digital or physical goods.

[3] Application designers have more freedom to build appealing, easy-to-use, and differentiated customer payment experiences. They can integrate payments data with other data streams such as check-out baskets, gaming, or budget visualization services.

[4] M-payments based on NFC technology will be deployed on a larger scale in Italy. For example, Telecom Italia, after holding a trial for proximity payments in Milan where users could buy tickets on public transport, pay at retail outlets and interact with smart advertising posters, in 2014 introduced TIM SmartPAY, a prepaid card for m-payments. Poste Italiane, Italy's state-owned postal service, has introduced NFC technology in post offices to allow clients to pay for bills, letters or parcels through their mobile phones.

A wide range of players have entered the m-payments market: banks (such as Barclays with its Pingit m-payment service), but also many non-banks, often with innovative solutions.

Mobile network operators (hereinafter "MNOs"), like Vodafone, MTN and Orange, have deployed m-payments services in several countries. Money transfer operators (hereinafter "MTOs"), like Western Union and MoneyGram, as well as card companies, like Visa, MasterCard and Amex, all underpin multiple m-payment initiatives. Payment services providers, like Paypal, are deeply present into m-payments.

MNOs have set up joint ventures between them, like the Isis consortium in the US or project Oscar in the UK. Other examples of joint ventures include Equity Bank with M-PESA, State Bank of India with Airtel, Banamex with America Movil, Alfa-Bank with VimpelCom, Garanti Bank with Turkcell and Avea. However, there is a need for further cooperation and partnerships.

2.2. M-payments and Financial Inclusion

The spread of mobile phones and the recent growth of m-payment services have been contributing to the focus on their potential for financial inclusion[5]. M-payments have allowed millions of people, who are otherwise excluded from the formal financial system, to perform financial transactions relatively cheaply, securely and reliably.

By the later part of the 2000s, the main action in m-payments was occurring in developing and less developed countries - from Kenya, to Brazil, the Philippines, South Africa - where m-payments are really attractive to unbanked and under-banked people because of the lack of bank branches. It has been proved that innovation often occurs where the need for change is greatest. In addition, in microfinance it is well known that the poor have limited liability since they do not have the possibility to lose anything. Thus, in poor

[5] Financial inclusion has become a subject of growing interest for researchers, policymakers and other financial sector stakeholders (*see* DEMIRGUC-KUNT- BECK - HONOHAN, *Finance for all? Policies and pitfalls in expanding access*, Washington, DC, World Bank, 2008). Without inclusive financial systems, individuals and firms need to rely on their own resources to meet their financial needs. Lack of access to finance can lead to poverty traps and inequality. Recent survey data from the World Bank (*see* WORLD BANK, *Remittance Prices Worldwide*, in *World Bank Policy Notes*, 2012), suggest that the costs of sending remittances through a traditional mode such as a commercial bank, is still substantial --about 12 percent on average. Alternative means for remitting money, especially those based on m-payments are relatively cheaper. Although not widely available, pre-paid card services and mobile services were the cheapest product types, with average costs of about 6 percent for both.

countries loss aversion may be slow and they may be more open to experimenting with new models of m-payments, as in Africa, for example, where there are few banks, poor physical infrastructures and a rural population often dependent on remittances from the city.[6]

Innovation is sometimes preceding legislation. The Central Bank of Kenya permitted experimentation (a "test-and-see" approach) which led to the M-PESA m-payments service. The success of M-PESA is a story of both innovative private sector investment as well as early stage commitment – through financing and appropriate oversight – of public sector actors[7].

There is a striking difference in attitude towards financial innovation among central banks. Instead of a "test-and-see" approach, some central banks have followed a more traditional path of legislation-regulation-innovation. The drawback is that this regulatory attitude can discourage innovation in the financial sector (and may help to explain the slow adoption of m-payments in regions where banking penetration rates remain low while cell phones become ubiquitous). The case of Philippines highlights the tradeoffs involved in creating an adequate regulatory framework for new credit market technologies. In the Philippines there is the presence of an adequate legal framework allowing alternative financial products/ services and e-money. In the Philippines, GCash is a highly successful mobile wallet service enabling cashless and cardless micro-transactions, including payments to shops and utilities and transfers to other people.

In other countries m-payments remain either governed by the same legal framework that applies to traditional banking services, which limits the ability of m-payments to reach previously financially excluded groups, or outside the scope of banking regulation, which potentially exposes mobile banking clients to significant risks.

While in many countries the financial inclusion policy is led by the central bank, this is not always the case. In Kenya, for example, the central bank was aided by the Department for International Development supported by Financial Sector Deepening Trusts and by survey research conducted by Finmark Trust. In Colombia, a government-created independent trust fund (Banca de Desarrollo) has led efforts on financial access. At the global level, the Alliance

[6] ASHTA, *Evolution of Mobile Banking Regulations,* April 1, 2010, available at SSRN: http://ssrn.com/abstract=1583080 or http://dx.doi.org/10.2139/ssrn.1583080, 4.

[7] A recent study estimates that M-PESA has reached at least 40 percent of the adult population after five years of operation and used by more than two-thirds of the households (JACK- SURI, *Mobile Money: The Economics of M-PESA,* in *NBER Working Papers*, No. 16721, 2011).

for Financial Inclusion (AFI), a non-government organization, has a policy program to promote dissemination of good practices.

2.3. M-Pesa in Kenya: Is It a Replicable Model?

There are a large number of potential business models for m-payment services, which may be led by either banks or operators. In some cases, the bank is the main driver of the business. In others, it is the MNOs by itself or in partnership with other banks and third party providers.

The model with a dominant player is exemplified by Kenya, the Philippines, Nigeria, Malaysia, Thailand and Indonesia.

The biggest success to-date is Safaricom's M-PESA in Kenya. The rapid growth of M-PESA caught everyone by surprise. In just one year M-PESA had 1 million clients. By early 2012 M-PESA had 15 million registered users, a network of over 35,000 cash-in and cash-out agents, and a transaction volume of US$665 million per month[8].

When M-PESA began in Kenya, it had no association with the formal banking sector and mobile banking customers there were exempt from the documentation requirements imposed by banks.

M-PESA started off as a popular platform on which people could send domestic remittances across distances at a low cost. As its popularity grew, its functionality also broadened as users began to leave funds in reserve on the platform, creating a kind of short-term savings device. With the success of Safaricom, many players quickly entered the field: as of Dec 2010, there were at least seven systems offering some type of bank account access via mobile phone. Most of these function on partially integrated mobile systems, where customers are first required to establish a traditional account in a physical bank, through which they could gain access via a mobile phone. On the other hand, M-KESHO, a joint-venture between Safaricom and Equity Bank, currently offers a fully integrated mobile savings system, where customers can sign up directly via Safaricom agents.

This model calls for a big player with a dominant market share and capacity to attract together the ecosystem (banks, cash in/out points and managers of such points) and aggregate transaction volumes. Big players, especially mobile operators, already have the majority of customers, a widely recognized

[8] OKUTTAH, *M-PESA Drives Safaricom as Profit Declines to Sh12.8bn*, in *Business Daily*, 2012, available at http://www.businessdailyafrica.com/Corporate+News/MPesa+drives+Safaricom+as+profit+declines+/-/539550/1403606/-/35hl1b/-/index.html.

brand and a distribution network which includes a large number of retail outlets in their territory.

Generally, though not always, the largest mobile operator in a country is in the strongest position to become the dominant player in m-payments. Incumbent mobile operators have brands with mass-market appeal, established retail channels and experience with a high volume transactional business model. Thus, from a regulatory stand-point, enabling the dominant player model hinges on permitting mobile operators to issue e-money and manage cash in/out points.

The dominant player model, such as M-PESA, has been less successful elsewhere. It is hard to create and more so to replicate. Big corporations with dominant market shares and high margins are not generally known for innovation and speed. Furthermore, this model requires authorities to closely monitor the competitive implications of a dominated model for potential abuses of market power. Correcting anti-competitive behavior is not an easy matter once a player has established dominance.

The discussion of M-PESA needs to consider its relative uniqueness - in terms of favorable regulatory and market conditions and of the prominent role of a telecommunication company in providing financial services - that allowed a single provider to capture significant economies of scale in a way that might be difficult to replicate (or not desirable) in other settings.

3. Toward a Flexible Decentralized Approach

3.1. Unbundling the M-payments system

In many other countries other than Kenya - such as in South Africa, India, Bangladesh, Tanzania and Uganda - financial regulators have been more conservative and insisted on a bank-led approach.

Established banks can embark on m-payment services with relatively low risk and cost. Unlike mobile operators, banks can exploit the arrangement of cash in/out points incrementally, since they already have an existing product range, a branch network and marketing channels. A bank could start by signing up a few cash in/out points around a few branches and over time build a

substantial base.[9] Above all, banks are already fully prudentially regulated and supervised.

However, a bank-based path can often be slow to develop.

Learning from more integrated approaches, which are easier to supervise, regulators may then develop a gradual approach towards a decentralized model. To develop such ecosystem, a sequence of coordinated actions by multiple and diverse players, without any single player emerging as the leader, are necessary.

M-payments should be understood as three entirely separable activities. *First*, there are the real-time transactional platforms which perform the fairly mechanical functions of account management and transaction authorization. *Second*, there is the intermediation of funds, which consists of the investment of the funds that are backing those accounts, channeling the resources back to productive opportunities in the wider economy. *Third*, there is the cash in/cash out business, which consists of helping customers exchange between two forms of money (cash and electronic value) against the store's own inventory of the same two forms of money.

The more these three businesses are bound into one by regulation, the harder it could be to create a m-payment network.

Regulators bind the account management and intermediation businesses whenever they require that payment platforms be operated (directly or indirectly) only by banks. Allowing non-banks to be e-money issuers is a good way of unbundling these two businesses. A growing number of regulators around the world are permitting non-bank e-money issuers, allowing non-banks to engage in the accounts management business as long as the banks retain the higher-risk intermediation business.

While regulators are increasingly unbinding account management from intermediation, regulators commonly continue to bind the account management and cash in/out businesses by requiring a tight contractual relationship between the retail cash in/out outlets and the account issuer. This is often compounded by a requirement that the account issuer assume responsibility for the actions of the retailers.

Such a flexible, decentralized approach is exemplified by the European Union, the United States and Japan.

[9] For mobile operators, m-payments need to reach scale quickly for them to have any chance of success. Money transfers require substantial network effects (in terms of number of customers in the system) and density of cash in/out points.

3.2. The Case of the European Union: the Directive on Payment Services (PSD)

M-payments constitute a new channel in which existing payment instruments in the EU, i.e. the so called "Single Euro Payments Area (hereinafter "SEPA") schemes" and "SEPA cards", can be utilized. The main focus is in the area of initiation and receipt of credit and debit payments (including card payments) through mobile phones. M-payments will then have to comply with the Payment Services Directive (hereinafter "PSD")[10] as well as with the existing rules for underlying SEPA instruments.

The PSD introduces a prudential framework for any entity or person, unregulated before the enactment of the Directive, who provides or wishes to provide payment services.

This requirement essentially aims to support the global fight against terrorist financing and money laundering, while at the same time having the potential side effect of stimulating further competition in the European payments market. Any person or business can decide to obtain a license under the PSD, which permits the provision of payment services as a payment institution (hereinafter "PI").

While a number of existing businesses will have to be regulated as a PI due to their core business activity (for example, money remitters), any other company that does not provide payment services at this point in time will have the choice under the PSD to obtain a PI license in addition to their core business allowing them to become a "hybrid payment institution".

The fact that PIs are enabled by the PSD to access open payment systems on a non-discriminatory basis (for example, no banking license requirement can be stipulated by those systems as an entry barrier) is likely to have a significant impact on what used to be the bank's remit only. Open payment systems will have to open their doors to PIs including "hybrid PIs" where the latter could pose specific risk issues that could emanate from their "other" business activity. However, an important concern remain with the "access to payment systems" provision,[11] as the exemption of closed-loop systems[12]

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[10] Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC.

[11] Article 3(b) PSD.

[12] Closed-loops systems are systems in which the movement of funds from a payer's account to a payee's account does not necessarily require connections with banks, although banks may be used to fund or redeem end user accounts with the end-to-end provider.

from these access provisions appears not to be in line with the goal of enhancing competition.

Compared to other countries around the world, the European Union has long lagged behind the emerging m-payment market.[13] As with m-payments, the lack of a concrete framework addressing main concerns, such as technical standards, security, inter-operability and the cooperation between market participants, risks perpetuating a fragmented m-payments market in Europe. The key market actors (MNOs, payment service providers, mobile phone manufacturers) have not yet agreed on a viable business model enabling inter-operable payment solutions.

4. An Enabling Policy and Regulatory Environment

4.1. Developing the case for Interoperability

M-payments users will fully benefit from competition, freedom of choice and more efficient payment operations if interoperability and some level of interconnection between competing m-payments schemes is achieved.

Some of the uncompetitive habits developed in the cards sector over the years must be prevented from spreading to m-payments. The lack of common standards in the domains relating to card payment's data exchanges between the merchant and the acquiring payment service provider and card payment's data exchanges between the acquiring and issuing payment service provider, as well as the different certification criteria and procedures in different member states, are illustrative examples of the present state of the market, despite efforts at integration.

Interoperability between m-payment solutions should be ensured by standardization, not regulation. The ideal option seems to be standardization through technical requirements and 'best practices' that are not too prescriptive. Regulatory enforcement of interoperability remains a risk because the business model is highly market-specific and still nascent in most countries. Following the regulatory route risks stifling innovation and is not appropriate for keeping pace with technology, fraud and market developments.

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[13] Recently, however, Apple, Google and Visa have all announced major drives to enter the m-payment business. Visa Europe and MasterCard Europe are taking steps to convince consumers to embrace m-payments, including a commitment to encourage merchants and banks to install the necessary software to handle mobile transactions.

The standards in question should be preferably open standards (that are freely available and are developed and maintained via a collaborative and consensus-driven process) and not proprietary standards (that are privately owned and generally not approved standard-setting bodies). Private players controlling the standards and, hence interoperability, will dominate the whole payment chain (the device itself, the application platform and security management) and there is a serious risk of fragmentation through proprietary solutions. In addition, the importance of other sectors potentially involved in interoperability without playing a leading role in the standardization strategy should not be overlooked, such as public transport (payments for ticketing) or health (health insurance card-based payments) sectors. However, standard setting bodies can take a long time to establish a standard, and often develop standards on the heels of the leader that has successfully imposed a proprietary platform.

While the existing standardized payment instruments could be used as a basis, we may request for the establishment of new and more neutral common standards, primarily due to the fact that the new payment channels in question amount to a new market, whose complexity is not comparable to the traditional bank-dominated markets. Given the specificity of m-payments, standardization should address the issue of portability of m-payment applications (i.e. how payment applications follow consumers when they change MNOs). Standardization of the various components (e.g. protocols, interfaces, applications, services) needs to be carried out thoroughly in order to minimize the risk of foreclosure of potential competitors or innovation.

At the heart of this issue lies a growing diffidence among incumbents to fully embrace open platform tactics. Carriers in particular seem hesitant to exploit the tactic of open collaboration through co-opetition to explore growth opportunities beyond traditional network assets above the level of the mobile operating-system (hereinafter “OS”). Trust in partnering on a collaborative, open-basis is lagging, and concerns that new products and services developed at the OS level will harm traditional network revenues, seem to be lingering.

This needs to change if incumbents want to avoid a long, arduous road to maintaining their dominance. Mobilizing and managing new open ecosystems becomes crucial to business model innovation, especially in light of recent sector events that are rapidly redrawing the competitive landscape.

At the end, m-payments providers should consider that, if they don’t interconnect their schemes, users will do it themselves: m-payments customers of the incumbent operator will most probably seek to transact beyond the relatively small closed loop of people who are on the same m-payments scheme and will do so by acquiring SIM cards from other operators; similarly, cash

merchants will seek to sign up with all competing m-payments schemes independently. Exclusivity will be hard to enforce, unless an operator has a very high market share, like Safaricom in Kenya had.

What m-payments providers should be focusing on is how to maximize the lock-in of their customers to their m-payments service: *on one hand*, interoperability augments the probability that customers will join the scheme by increasing the incentives to join; *on the other hand*, interoperability may reduce lock-in by making it easier for customers to leave, if they feel that other schemes can deliver on an equally large network. Providers should then focus on the probability that their customers will choose not to leave.

It usually comes down to whether the players involved opt to maximize the total size of the pie or just their slice of the pie. In networked businesses, in general, the more the players work together to enlarge the pie, the larger the slice each one will get. MNOs have a tradition of interconnecting their voice and data bearer services, allowing their customers to send and receive messages to/from anyone, even if they are on a different network. However, we haven't yet seen this logic extend to m-payments.

We can cite three recent examples to illustrate the impact of unbundling and interoperability on service take-up.

First, usage of SMS services in the United Kingdom ascended following the introduction of interoperability in 1999 – two years after the service was first launched (a 70-fold increase in messages per month was reported by 2002).

Second, a similar example can be cited for credit card use. The growth of credit card services mirrored that of m-payments, whereby an initial rapid deployment slowed in the face of low usage. This was followed by an exponential growth immediately after interoperability was introduced.

Third, in India the government introduced regulations in 2008 requiring that m-payments schemes be operated by banks, making it difficult for an M-PESA–type market entrant to lead the nascent m-payment movement. This has probably contributed to the slow growth of m-payments in India. *However*, recently the National Payments Corporation of India (NPCI) has created a micro-switch enabling m-payments between accounts of participating banks. According to Ignacio Mas, if all the banks and any licensed nonbank account issuers join and set the interchange fee low enough, then any retailer could in principle declare itself a cash in/out point for any bank simply by virtue of having an account with one participating bank. In such situation, banks would not need to build and manage their own cash in/out networks because they would have access to the emerging network of cash in/out points. In addition, non-banks would have the opportunity to offer services to a wide range of

their customers (not only the customers of one bank) by maintaining a single bank account.[14]

4.2. A Functional Approach to Regulation

The full potential of m-payments for financial inclusion is yet to be realized. Few policy and regulatory environments are genuinely enabling. In many countries, significant regulatory barriers persist that constrain an operator's ability to build sustainable m-payments services.

First, against the evidence coming from a number of countries where m-payments has been successfully deployed, some financial sector authorities refuse to license nonbank payment providers or e-money issuers.

Second, several financial regulators still impose account-opening requirements that the poor cannot meet, a conservative approach to interpreting the standards of the Financial Action Task Force (hereinafter "FATF") that doesn't take into account the risk-based approach recommended by the FATF, the FATF guidelines on financial inclusion and the experience of progressive countries that have adopted alternative and simplified opening procedures to overcome the obstacle represented by traditional identification criteria.

Third, there is a lack of understanding with the risks of moving financial transactions outside of bank branches. In a number of countries it is still difficult, if not impossible, for MNOs to appoint cash merchants without which the m-payments business case and potential for financial inclusion is substantially degraded. Specifically, the regulations that prohibit banks, e-money issuers and remittance operators from engaging third party agents to carry out customer acquisition functions and cash services create a significant barrier to commercially viable implementation models.

These regulations have prohibited the first movers from performing roles or creating partnerships that are required to build a compelling customer value proposition as well as a commercially viable service channel for mass market m-payments. An unbundled m-payments system should not be viewed, however, as a deregulated one. Governments can play an important role in facilitating access to m-payments.

For example, governments can support financial inclusion through increasing the extent to which Government payments are channeled through the financial sector. The discussion of the potential role of government payments

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[14] MAS, *Enabling different paths to the development of Mobile Money ecosystems, Mobile Money for the Unbanked*, in *Annual Report 2011*, 3.

in expanding financial inclusion of both households and firms could be further sharpened to focus on those specific features of electronic government payment systems which play a pivotal role in determining whether the new government payment mechanisms are financial-inclusion friendly, neutral, or actually impede the emergence of a more inclusive financial system.

Government measures to limit cash payments[15] will also be one of the main drivers to speed the adoption of electronic payments through mobile phones.

One of the main steps is introducing risk-based regulations.[16] The providers of retail payment services (which can be banks, e-money issuers, telecom operators, etc.) should not be regulated differently, depending on whether they are a bank or not. A more appropriate approach may be a functional one i.e. the provision of payment services should be regulated the same way independently of the status of the provider (i.e. whether it is a bank or not). This approach has been followed, for example, in the EU, with the adoption of the PSD and the E-money Directive.

In an unbundled regulatory framework, there would not be a central party assuming all responsibilities. Instead, all risks would need to be carefully thought through and assigned to the right player. The bank intermediating the funds should be subject to all the prudential requirements that Basel and governments impose. The entity managing the accounts (whether a bank or non-bank) should be fully responsible for the operational and technological integrity of their platform in all its aspects. Cash in/out outlets would be responsible for implementing all the necessary consumer protection measures.

Adopting a risk-based approach to the so called "know your customer (hereinafter "KYC") rules", would simplify the KYC requirements for basic, no frill-type accounts. The strict KYC rules employed in some markets place a prohibitive cost on service providers that will ultimately reduce the risk profile of a country by decreasing the amount of cash used. Cash is the least-favorable of all payment options from this perspective because it is anonymous, untraceable and can easily be damaged, forged and transported across borders. Among the solutions regulators should favor is a tiered approach to KYC, where small amounts of money may be paid and transferred with only minimal formal identification provided. Such an approach has already been

[15] Prime Minister Mario Monti in 2011 banned cash payments of over 1,000 euros ($1,300) as he sought to crack down on tax evasion. Italy loses more than 100 billion euros in unpaid taxes every year.

[16] LYMAN-PICKENS- PORTEOUS, *Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance*, in *CGAP Focus Note*, No. 43, 2008.

adopted in Mexico, where providers placed a limit of USD 24 per day on transactions before requiring increased identification.

4.3. The Access Dilemma

A significant aspect of regulating m-payments relates, at least in the EU, to the question of whether non-bank actors should be allowed access to bank account information in order to check whether such accounts contain adequate funds. Information on the availability of funds is necessary for obtaining the requisite authorisations and payment guarantees that are essential for the business model of most payment services. Banks have a "gateway function" to such information.

In the EU, the European Commission is of the view that this access should be opened up to more actors, in order to minimise barriers to entry, subject to certain safeguards, for example, obtaining the agreement of the customer so as to ensure that the new system is "at least as safe and as confidential as the present one". *However*, the scope of these safeguards and the question of how the access in question will operate in practice are the source of various complications. The current legal and regulatory framework does not consistently meet the challenges that arise relating to access to payment accounts required by non-bank unregulated entities. For example, as these entities do not clearly fall within one of the categories of the PSD, they are not subject to its provisions on duties and liabilities.

To address this issue is necessary to consider how to balance the request for access by unregulated actors without unduly burdening banks from a liability or cost perspective (in the form, for example, of investments in security) and without undermining consumer confidence, data security, data protection and bank secrecy. Moreover, it will be essential to ensure that there is a level playing field between the actors in question, by bringing the relevant non-bank entities within the scope of regulation and prudential supervision and by ensuring that in the event of fraud or information misappropriation, the liabilities are correctly apportioned between the actors. Resolving the access dilemma will most probably entail regulatory change in the EU. This is aimed at ensuring that technological evolution and market needs are met.

5. Conclusions

The full potential of m-payments for financial inclusion is yet to be realized in the current regulatory regime, but likely to flourish if specific barriers

and/or regulatory uncertainty are removed from existing regulations in many countries. Policy makers and regulators should build the capacity to engage and maintain an active, experimental approach, shaping the regulatory environment so as to enable experimentation and eventually increase their control and oversight through different phases of market development, carefully sequencing their proportionate response to risks.

By the later part of the 2000s, the main action in m-payments was occurring in developing and less-developed countries: from Kenya, to Brazil, the Philippines, South Africa, where m-payments are really attractive to unbanked and under-banked people because of the lack of bank branches. It has been proved that innovation often occurs where the need for change is greatest. In addition, in less-developed countries loss aversion may be slow and they may be more open to experimenting with new model of m-payments.

While M-PESA in Kenya is a brilliant story about the significant potential of m-payments, it remains the single story that we always cite when discussing this issue. After several years of citing this extremely good case study, it begins to beg the question as to whether this is really a replicable model. Several other up and coming examples may provide confidence that there really is potential beyond M-PESA.

Today, the PSD may serve as a benchmark. The Directive, which provides the legal foundation for the creation of an EU-wide single market for payments, seeks to improve competition by opening up payment markets to new entrants, differing from banks, thus fostering greater efficiency and cost-reduction. The draft revised PSD (PSD II)[17] would further extend the scope of the PSD to cover new services and service providers enabling access to consumer accounts, thus aiming at bringing the legislation up to speed with developments in m-payments.

Regulators should understand and encourage non-bank providers. While banks continue to have an essential role, non-banks also have vital roles (e.g. as hosts of payment platforms, providers of retail payment instruments, managers of agent networks). The inability of the industry to conceive of small operators as providers of payment services of the same kind as banks, although under different business schemes, has led to dangerous misconceptions, which do not individually benefit either the traditional operators or the new entrants, but above all seriously damage final users, who lacked adequate protection and paid the price of closed markets. Final users pay the cost of oligopolies

[17] Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC, COM(2013) 547 final, 2013/0264 (COD).

generated by the often-imposed cooperation between banks and new services providers.

The degree to which m-payments is capturing the non-banked market clearly differs across economies and it will depend on the market as to which is more suitable. Socio-economic factors (e.g. urbanization, emigration, computer literacy, availability and penetration of banking infrastructures as well as on how the identified drivers for and barriers to innovations will work in the specific context) strongly differ across countries. This may reflect the varied and quickly evolving public policies surrounding m-payments.

It is still too early to know which path is most likely to succeed in the long run. An m-payments scheme may be successful in one country, but will not necessarily perform as well in other countries. The industry as a whole is still working to demonstrate the viability of different models and partnership arrangements. Players are competing and partnering with each other in hard-to-figure-out ways.

Today, however, technology is accelerating. Furthermore, new entrants raise questions on standardization and interoperability at both domestic and global level. This will lead to more convergence in m-payments at the global level. Ongoing sharing with peer regulators about emerging experiences will then help the learning process. This article supports a policy roadmap that focuses on specific regulatory changes, and parallel development of appropriate oversight capacity, based on mutual regulatory learning.

OVERVIEW OF DIRECTIVE 2014/92/EU [DR GABRIELLA GIMIGLIANO, UNIVERSITY OF SIENA]

Directive 2014/92/EU on *The comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features* (hereafter, the Directive) may be considered as one of the pillars of the European integration process for payment services.
On the one side, the Directive is applied to consumers, and on the other to payment service providers.
The definition of 'consumer' follows the traditional standards and covers "*any natural person who is acting for purposes which are outside his trade, business, craft or profession*" (art.2, n.1). Regarding the concept of payment services, the Directive draws a difference between the payment service providers (i.e.: the payment institutions as laid down under dir. 2007/64/EC) and the credit institutions providing that the provisions on transparency and comparability of payment services fees are generally applied while only credit institutions are bound to offer a payment account with basic features.
Generally speaking, the Directive aims to increase the level of competition in the single market and reach to a great extent the unbanked people who are legally resident in the Union, namely the European citizens and "*third country nationals who already benefit from rights conferred upon them by Union acts*" as well as people seeking asylum under Geneva Convention (1951).
The pro-competitive objective mostly deals with payment services fees in the execution of a payment account. A distinction is made between the fee information document and the statement of fees: while the former is handed or delivered to the consumer on paper or another durable device before entering into a contract for a payment account, the latter informs the consumers about the fees incurred yearly and free of charge. In comparison with the information duties laid down in directive 2007/64/EC (hereafter, PSD), this Directive not only raises the level of formalization in transparency rules and regulations, but also pays careful attention to the provision of trans-border payment services. Indeed, the Directive provides that

- Member States must establish a list of 10 to 20 of the most representative "*services linked to a payment account*" and subject to a fee to be included both in the fee information document and in the statement of fee. When the Directive refers to "*services linked to a payment account*", it means "*all services related to the opening, operating and closing of a payment account, including payment services and payment transactions falling within the scope of the point (g) of Article 3*

of Directive 2007/64/EC and overdraft facilities and overrunning" (art. 2, n.6)

- When one or more payment services are offered as part of a package of services linked to a payment account, the fee information document must disclose not only the fee for the whole package, the services enclosed and their quantity but also the additional fee for any service exceeding the quantity covered by the package fee
- The consumers are informed in advance of the overdraft interest rate applied to the payment account and the total amount of interest charges relating to the overdraft during the relevant period
- Member States set up at least one website comparing fees charged by payment service providers free of charge

Furthermore, the Directive attempts to ease the switching service and no nationality discrimination is permitted. The "switching service" allows the consumer, upon individual request, to transfer from one service provider to another the information about all or some standing orders for credit transfers, recurring direct debit and recurring credit transfers executed on a payment account, as well as any payment account balance, with or without closing the former payment account. It is worthy of mention that, in order to increase cross-border customer mobility, the Directive allows consumers to switch for some of the standing orders. Indeed, according to the preamble (32) "*the consumer should be allowed to ask the new payment service providers to set up on the new payment account all or part of the standing orders for credit transfers, accept direct debits from the date specified by the consumer* (…)".
Finally, the Directive establishes that consumers – namely, people legally resident in the European Union – be guaranteed access to a range of basic payment services. To this end, the Directive establishes that credit institutions must largely offer payment accounts "*with basic features* in order to allow them to open, operate and close the payment account, to place and withdraw funds within the Union from a payment account or an automated teller machine, as well as being able to execut payment transactions by direct debit, payment cards and credit transfers (no credit card payment). This kind of service must be offered free of charge or for a reasonable fee.
Therefore, every consumer has the right to a "*payment account with basic features*", but he is entitled to only one account: in fact credit institutions may be allowed to refuse an application for a payment account with basic features where a consumer already holds a payment account with a credit institution "*located in their territory*" (art. 16, para.5).

In conclusion, some observations and a couple of questions:

- The Directive increases the level of formalization of transparency duties, but it does not lay down Community-based legal consequences whenever the payment service providers do not comply with the rules
- The Directive excludes the notion of micro-enterprises from the definition of consumer despite the provisions of directive 2007/64/EC;
- Any person legally resident in the European Union has the right to a payment account: is this a way to equalize fiduciary money to currency in legal terms without any formal recognition?
- More than once, the European lawmaker has taken regulatory action (regulation or directive) to remove legal obstacles to building up a single market for payment services: maybe one should question whether the “market” works properly and whether payment services may be treated like financial or banking services in the European Union.

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