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IN EUROPE'S SHADOW: OBSTACLES TO MONETARY UNION AND COMMON PAYMENT SYSTEMS IN THE GULF COOPERATION COUNCIL

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The paper focuses on the obstacles faced during the last decades in establishing a monetary union and a common payment systems among the countries part of the Gulf Cooperation Council (GCC), and on the feasibility of a new trend for harmonization in such fields. The research emphasises that the adoption of common currency and unified regulations for payments might strengthen the economy of the middle-eastern region and enhance the development of countries that have historically based their politics on the profits originated by oil-refining and gas production.

Starting from the failures in undertaking concrete actions in the mentioned sectors the study will try to shed light on the following aspects: 1) Can the common currency be a valid alternative to the exchange rate arrangements made by the GCC countries? 2) Is the enforcement of monetary union and unique payment systems a fundamental step towards the establishment of an internal market capable to attract more investments in the Region and to booster the Gulf economy?

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1. Introduction

The economic cooperation and integration, along with the current attempts to diversify the Gulf economy in sectors others than the natural sources, especially the oil, has been one of the main concerns of the political, economic, social and regional alliance among six Middle Eastern Countries established in Riyadh on 25th May 1981, known as Cooperation Council for the Arab States of the Gulf (hereinafter GCC)[1].

All the development plans recently adopted by the local Governments testify that strenuous efforts are being made to ensure the stability of incomes in the Region and their sustainability for the future. Despite such national endeavours, the inception of an effective common market in the area seems to be a fundamental step for the growth of economic systems whose main strength is the attraction of foreign investors.

Over the last decades the GCC have been undertaking a number of actions for the establishment of a Free Trade Area, a Custom Union, and a Common Market, but the process of unification is still under completion. Indeed, in order to build up a unique economic area two main actions have to be accomplished. The first is the adoption of a monetary union, as alternative to the *de facto* US dollar peg regime for the national currencies, with all the consequential damages related to the large swings in global commodity prices in the short to medium run[2]; the second is the enforcement of unified rules for payments, 'oil in the wheels' of any internal common market.

Several times the middle-eastern decision makers have discussed the feasibility of such endeavours, but till now no further clear official positions have been expressed. For this reason the paper will firstly examine the obstacles encountered by the GCC in implementing a common monetary policy, and then will check over the current *status* of the single currency agenda.

Inasmuch to steel a wider internal market project and attract more foreign investments in a regional block a second important step is required, that is the enactment of a legal framework for the establishment of a 'Pan-Arab Single

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[1] On the Gulf Cooperation Council see, *inter alia*, S. COLOMBO (2014), *Bringing the Gulf: Eu-GCC Relations at a Crossroads*, Ed. Nuova Cultura; P. BOREA (2014), *Studies on Arab Regionalism: the Gulf Cooperation Council*, Ed. Aracne; N. PARTRICK (2011), *The GCC: Gulf State Integration or Leadership Cooperation?,* Kuwait Program on Development, Governance and Globalization in the Gulf States Research Papers, Vol. 19, The London School of Economics and Political Science; R. YOUNGS (2011), *The Gulf Region in the Global Economic Context*, Gulf Research Centre; R. ALASFOOR (2007), *The Gulf Cooperation Council: its Nature and Achievements. A Political Analysis of Regional Integration of the GCC States 1974-2004*, Lund University Press.

[2] An assessment of the economic implications of exchange rate regime existing in the GCC, can be read in S. BASHER (2015), *Regional Initiative in the Gulf Arab States: the Search for a Common Currency*, *International Journal of Islamic and Middle Eastern Finance and Management*, Vol. 8 No. 2, pg. 185. The Author also suggests some alternatives to the pegging system to the US dollar adopted by all the GCC Members, except for Kuwait.

Payment Area', the study will review the underlined rationale for a regulation in the field of payment services and will scrutinize the goals set out by the Council in this regard.

Conclusively, the paper will provide arguments in support of the harmonization, comparing the Gulf experience with the European Union model, and will offer a template for the GCC countries in the direction of a real economic diversification as basis for the sustainable growth in the Region.

2. Economic Integration among the Gulf States. The Construction Process

Before the discovery of the oil, the economy of the Arab Gulf States relied mostly on pearl fishing, export of typical goods such as dates, trade of gold and re-exporting of items carried from India and Africa, but the finding of the 'black gold' between the 1950s and 1970s altered the way of life and transformed these countries from underdeveloped states into developing areas.

Such transformation has been reflected in GCC's economic objectives, as set forth in four official documents adopted by the GCC Supreme Council, namely the GCC Charter entered into force in 1981, the 1981 Unified Economic Agreement (UEA), the 2001 Economic Agreement, and the 2008 Monetary Union Agreement; a further basic tool for the joint action process is represented by the resolutions of the Supreme Council, especially the one on the creation of a common market issued at its 23rd session, held in Doha in 2002.

The fact that integration and coherence amongst the GCC States in the economic field constitutes one of the main goal of such regional alliance has been made clear since the enactment of the institutional charter, whose art. 4 identifies the main objectives of the GCC by making a precise reference to the development of uniform rules in the field of economic and financial affairs, trade and customs[3]. Moreover, the 1981 Unified Economic Agreement, legal basis for the establishment of a Free Trade Area, since its Preamble points out that the main aim of such agreement is 'to develop, extend and enhance the economic ties [among the member states] on solid foundations, in the best

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[3] Art. 4 of the GCC Charter, available at http://www.gcc-sg.org/en-us/AboutGCC/Pages/Primarylaw.aspx (Accessed on 3 July, 2016) establishes the objectives of the GCC as follows: 'The basic objectives of the Cooperation Council are as follows: (1) To effect coordination, integration, and interconnection among member states in all fields in order to achieve unity among them. (2) To deepen and strengthen relations, links and areas of cooperation now prevailing among their people in various fields. (3) To formulate similar regulations in various fields including the following: (a) Economic and financial affairs. (b) Commerce, customs and communications. (c) Education and Culture (d) Social and health affairs. (e) Information and tourism. (f) Legislative and administrative affairs. (4) To stimulate scientific and technological progress in the fields of industry, mining, agriculture, water and animal resources, to establish scientific research, to establish joint ventures and encourage cooperation by the private sector for the good of their people.'

interest of their people and for the sake of working to coordinate and standardize their economic, financial and monetary policies, as well as their commercial and industrial legislation, and customs regulations'. The said Agreement, as declared by the GCC representatives, constitutes the core of the integration program that has been developed in details over the twenty years following the establishment of the GCC, which includes:

1. Achieving economic nationality among the GCC citizens.
2. Achieving the economic integration among Member States in gradual steps, beginning with the establishment of the Free Trade Area, the Customs Union, the Common Market and ending with the establishment of the Monetary and Economic Union and the necessary common institutions.
3. Convergence and unification of laws, regulations and strategies in the economic, financial and trade areas.
4. Interconnecting the infrastructures in Member States, particularly in areas of communications, electricity and gas and promoting the establishment of joint ventures[4].

Additionally the 2001 Economic Agreement, while trying to implement the joint economic process in the Gulf and shift the action from the stage of coordination to the following stage of integration, lays down the ground for the Customs Union, enforced starting from 2003[5], and tills the soil for further developments towards the creation of a Common Market[6]. Such goals have been bolstered in the closing statement of the 23rd Session of the GCC Supreme Council, which has given the directives to meet the prerequisites of the

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[4] See the GCC official website at http://www.gcc-sg.org/en-us/CooperationAndAchievements/Achievements/EconomicCooperation/JointActionProcess/Pages/TheUnifiedEconomicAgreement198.aspx (Accessed on 3 July, 2016). The FTA exempted industrial, agriculture, and natural resources from custom duties, but these products must acquire a certificate of origin from the competent authority before entering the GCC. With this step the GCC countries became a single body of customs towards the outside world, since the tariffs on foreign goods will only be taken once in the entry point, and all these goods can move among the GCC duty-free. However the first port that collects the goods is responsible for the inception of the foreign goods and ensure that the goods are legal, fulfilled all required documents and meet the custom duties. The Agreement entered into force in March 1983 and lasted about 20 years till the end of 2002, when it was replaced by the GCC Custom Union.

[5] See Art. 1 of the Agreement, available at https://www.gcc-sg.org/eng/, which states that: 'Trade between the GCC member States will be conducted within the framework of a customs union that will be implemented no later than the first of January 2003. It shall include, at a minimum, the following: i. A common external customs tariff (CET). ii. Common customs regulations and procedures. iii. Single entry point where customs duties are collected. iv. Elimination of all tariff and non-tariff barriers, while taking into consideration laws of agricultural and veterinarian quarantine, as well as rules regarding prohibited and restricted goods. v. Goods produced in any Member State shall be accorded the same treatment as national products.'

[6] Art. 3 of the Agreement asserts the principle of equality in the treatment of the citizens of all Member states in all economic activities, and concludes by stipulating that 'Member States shall agree to complete implementation rules sufficient to carry this out and bring into being the Gulf Common Market.'

Common Gulf Market as soon as possible -in any case not later than the year 2007-, and has adopted a mechanism for following up the progress of the Common Market, within a fixed time frame[7].

The first step for the enforcement of the economic integration program is the achievement of the 'economic citizenship', that is to say the realization of a fully equal treatment among GCC nationals in all economic fields in the Member States, starting from the 'four freedoms' listed as follows by art. 8 of the 1981 Agreement:

1. Freedom of movement, work and residence.
2. Right of ownership, inheritance and will.
3. Freedom of exercising economic activity.
4. Free movement of capitals.

At a later time, the 2001 Economic Agreement tended to the direct implementation of the concept of economic nationality as tool for the achievement of a real Common Market, by according the GCC nationals residing in any Member State the same treatment granted to its citizens without differentiation or discrimination in ten general economic fields, included movement, residence, work, real estate ownership, capital movement, tax treatment, education, health and social services[8]. Thereafter the Council has entrusted the Financial and Economic Cooperation Committee, composed of the Ministers of Finance and Economy, with the duty to undertake the necessary actions towards the enforcement of such provisions.

3. A Monetary Union for the GCC: *Adelante Pedro, con Juicio*

Both a blessing and a curse of the joint economic action, the introduction of a monetary union has been an overriding concern of the GCC since its early stage, because it represents the ultimate goal of an economic process that have already

[7] See http://www.gcc-sg.org/en-us/Statements/SupremeCouncil/Pages/Twenty ThirdSession.aspx (Accessed on 4 July 2016). The resolution identified a time schedule for completion of the requirements of the GCC Common Market, as follows: a) Equal treatment shall be accorded to the GCC citizens by 2003 in the field of employment in the private sector, Stock ownership, formation of corporations and elimination of relevant barriers. b) Equal treatment shall be accorded to the GCC citizens by 2005 in the field of government jobs, social insurance and pension and elimination of relevant barriers. c) Competent committees shall complete all requirements to ensure achievement of the GCC Common Market by 2007 at the latest. Subsequently, the Secretariat issued two further resolutions declaring the official launch of the Common Market and the need for specific rules and procedures.

[8] See Art. 3 of the Agreement. Further details on the official steps taken in this regard, http://www.gcc-sg.org/en-us/CooperationAndAchievements/Achievements/Economic Cooperation/TheGCCCommonMarketandEconomicnationality/Stepshavebeentakentoachieveec onomiccitizenship/pages/Home.aspx. The main achievements in the sector of the economic cooperation are listed at http://www.gcc-sg.org/en-us/CooperationAndAchievements/ Achievements/Pages/Default.aspx (Accessed on 5 July, 2016).

fully experienced three of the classical degrees towards the integration, namely the Free Trade Area for the period 1983-2002, the Custom Union in 2003 and the Common Market in 2007, and is now halted at the fourth stage which stipulates the need for unified monetary, banking, and fiscal policies and issuance of a single currency [9].

Despite the signature of a specific agreement in December 2008, the adoption of the common currency is still far from the concrete implementation due, on one hand, to the fear of some of the Members to give away part of the wealth connected to the higher value of their national currencies and to surrender part of the domestic monetary sovereignty; on the other hand, because of the existence of bitter contrasts on establishment and location of the central institutions which will be in charge with the power to administer the new currency and the related policies.

Indeed the project of monetary union and single currency seems to be the hard core of the GCC 'dream' since it has been expressively mentioned even before the enactment of the Monetary Union Agreement, as it is evident by analyzing the two previous economic agreements that make a clear reference to the necessity of a unique monetary policy as final goal of the economic integration in the Middle East[10].

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[9] On the project for the monetary union, see A. ABDUSSALAM-M. FEAD-R. LUKMAN (2015), *Is a Single Currency Agenda Still Feasible in the Gulf Cooperation Council? A Qualitative Meta-Analysis*, Proceedings of 11th International Business and Social Science Research Conference 8 - 9 January, 2015, Crowne Plaza Hotel, Dubai, available at http://www.wbiworldconpro.com/uploads/dubai-conference-2015-january/economics/1420262535_228-Aljadani.pdf; M.S. KHAN (2009), *The GCC Monetary Union: Choice of Exchange Rate Regime*, Peterson Institute for International Economics, Working Paper Series No. 09-01; E.J. RUTLEDGE (2009), *Monetary Union in the Gulf: Prospects for a Single Currency in the Arabian Peninsula, Routledge*; S. ABU-BADER-A.S. ABU-QARN (2006), *On the Optimality of a GCC Monetary Union: Structural VAR, Common Trends and Common Cycles Evidence*, Monaster Center for Economic Research Ben-Gurion University of the Negev, Discussion Paper No. 6/11; K.L. ABDULRAHMAN AL-MANSOURI-C. DZIOBEK (2006), *Providing Official Statistics for the Common Market and Monetary Union in the Gulf Cooperation Council (GCC) Countries - A Case for 'Gulfstat'*, International Monetary Fund, Working Paper Serious No. 06/38; U. FASANO- A. SCHAECHTER (2003), *Monetary Union among Member Countries of the Gulf Cooperation Council*, *International Monetary Fund*; G.T. ABED-S. NURI ERBAS-B. GUERAMI (2003), *The GCC Monetary Union: Some Considerations for the Exchange Rate Regime*, International Monetary Fund, Working Paper Serious, No. 03/66.

[10] Art. 22 of the 1981 UEA states that 'Member States shall seek to coordinate their financial, monetary and banking policies and enhance cooperation between monetary agencies and central banks, including the endeavor to establish a joint currency in order to further support their economy.' Moreover, art. 4 of the 2001 Economic Agreement establishes: 'For the purpose of achieving a monetary and economic union between Member states. Including currency unification, Member states shall undertake, according to a specific timetable, to achieve the requirements of this union. These include the achievement of a high level of harmonization between Member states in all economic policies, especially fiscal and monetary policies, banking legislation, setting criteria to approximate rates of economic performance related to fiscal and monetary stability, such as rates of budgetary deficit, indebtedness, and price levels.'

Composed of 28 provisions, the GCC Monetary Union Agreement firstly lays down the legal and organizational foundations towards a concrete unification, through the implementation of the following basic principles:

1. Coordination of economic policies in order to achieve a high degree of convergence throughout the single currency area.
2. Creation of common financial infrastructures related to payment systems.
3. Adoption of uniform banking legislation as legal basis of the monetary and financial stability.
4. Establishment of a Monetary Council as preliminary body before the creation of a Central Bank.
5. Introduction of a single currency as replacement of the national currencies[11].

In six detailed Chapters the Agreement further sets out rules, methods, and procedures for the realization of the single monetary system in the Gulf to be enforced by 2010. Subsequently, in 2009 the GCC Member states have decided the establishment of a Monetary Council to serve as a transition body in preparation for the issuance of the common currency.

Furthermore in the GCC summit held in December 2011, Bahrain, Kuwait, Qatar and Saudi Arabia agreed on the establishment of a unified Central Bank operating from the year 2015 along with the national central banks in tune with shared monetary policies. The project has been not carried out yet, and notwithstanding the above mentioned regulatory actions, the Gulf Arab States are still in search for a common currency.

The causes of such a debacle can be variously identified by observing the inherent nature of the regional block, which does not properly constitute a union comparable to the structure of the European Union, but is rather a coalition among countries geographically close that are characterized by shared identity, tradition, culture, religion, language, social structure and similar governmental systems. Consequently, in case of disagreement, each States is free to pull back from the talks and take independent decisions as deemed appropriate for its nation.

Another reason why the plan has reached a deadlock is represented by the fact that, even though the economic harmonization has been a major goal of the GCC since the beginning, the Council has been conceived as a regional security alliance amongst countries continuously threated by conflicts for the power-sharing[12].

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[11] See Art. 3 of the Agreement.

[12] The conflicts that have driven the Gulf Countries into the GCC are: the Islamic Revolution in Iran and the Soviet invasion in Afghanistan in 1979, and the Iranian-Iraqi war in 1980. On the historical background of the Council, see S. TAKAJI (2012), *Establishing Monetary Union in the Gulf Cooperation Council: What Lesson for Regional Cooperation?, Asian Development Bank Institute*, Working Paper Series, No. 390, pg. 3. The Author also suggests that the GCC is unique for the fact that the survival of the existing monarchic regime appears to have been the primary motive of its launch.

Some scholars support the idea that in order for the monetary union to succeed is fundamental the creation of a fiscal union, which could lead to the collection of money in a special 'anti-crisis fund' to be used for covering the economic and social costs of unforeseen crisis, and avoiding the risk of debt crisis seasoned in other unified economic areas, such as the European Union[13]. Others stress that although the monetary union in the Gulf makes good economic sense, the project faces significant headwinds in terms of low intra-regional trade, lack of supranational political institutions and gaps in research capacity[14].

Indeed, one of the main bone of contention among the political leaders is represented by their unwillingness to renounce to the monopoly over the national banking policies, and to the power of issuing money, classical examples of the mastery and influence exercised by any government on the domestic and international market[15].

In spite of the aforementioned discrepancies in finalizing the take-off of the single currency agenda, it is unquestionable that the introduction of a unique currency may solve some the problems experienced in the GCC countries as consequence of the floating exchange rate regime, due to the fact that the adoption of a shared monetary system assures at least cost savings, price transparency and the overall stability of prices. Moreover, by the medium of a monetary union the Gulf Governments could increase their import purchasing power and products differentiation, attract a higher volume of foreign direct investments and, more in general, propel the local wealth through a joint development plan based on the diversification of the economic activities as response to the concerns on the remaining quantity of 'black gold' and gas in the Region.

In any case it has to be noted that, while negotiating on the effective possibility to create a central institutional apparatus for monetary cooperation, each Member State is currently fabricating provisional internal solutions for the reduction of the dependence on a limited number of exports commodities. The

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[13] In this regard see S. BASHER, cit., pg. 189, who, by examining the European debt crisis, conclude that 'A common monetary policy may sometimes fail to stabilize asymmetric shocks across members, which makes the case for insurance arrangements among members to provide transfers to countries in more dire circumstances. A fiscal union thus works as an automatic stabilizer across regions, providing adequate buffers against asymmetric macroeconomic shocks in a currency union.'

[14] Among others, see K.R. ALKHATER (2012), *The Monetary Union of the Gulf Cooperation Council and Structural Changes in the Global Economy: Aspirations, Challenges, and Long-Term Strategic Benefits*, Arab Center for Research and Policy Studies, Doha; A. ALKHOLIFEY-A. ALRESHAN (2010), *GCC Monetary Union*, *IFC Bulletin*, Vol. 32, pg. 17; W.H. BUITER (2008), *Economic, Political and Institutional Prerequisites for Monetary Union among the Members of the Gulf Cooperation Council*, *Open Economies Review*, Vol. 19, No. 5, pg. 579.

[15] One of the reasons for the stall in the negotiations regarding the monetary union has been the withdrawal from the project in 2009 of Oman and the UAE, which disagreed with the choice of placing the headquarters of the future Central Bank in the Kingdom of Saudi Arabia.

local decision makers have in fact launched development plans and national economic strategies – known as 'visions' – for the realization of sustainable and stable incomes no longer stuck on the oil-refining and gas extraction, but mainly focused on pioneering private investments, increased levels of innovation, and enhanced percentage of non-oil exports[16].

4. Common Rules for the Payment Systems: Here We Go!

When it comes to undertake actions towards the creation of a regional economic space, one of the aspects to be considered in order to strengthen the commercial transactions is the elimination of barriers to cross-borders payments, which can add costs for consumers and businesses. This is especially true in countries that recently declared sustainability, fairness and competitiveness as the three guiding principles for the implementation of their turnover[17]. The enforcement of harmonized rules in the banking sector is truly a priority to legal systems that strive for becoming the hub of the international business activities through the attraction of foreign direct investments.

The debate on such aspect has only been incidental over the years, and no specific legislation has been introduced at GCC level. Very few references to the necessity of a unified regulation in the field of payment systems can be traced across the economic and monetary agreements in force. In particular, the 1981 UEA states in the Preamble that one of the objectives of the regional block is the convergence of the laws and strategies on the economic and financial services; in a couple of provisions it also states that the Members shall seek for coordination with regard to the financial, monetary and banking policies, and shall enhance the cooperation between monetary agencies and central banks[18]. The same principles are fully reaffirmed as milestones in the 2001 Economic Agreement[19] as well as included within the basic principles of the Monetary Union Treaty[20], which lists among the tasks of the Monetary Council to be put into place the "ensuring of readiness of the payments"[21], and entrusts the constituent Central Bank with the duty of "enhancing effective infrastructures

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[16] For more details, see the Kingdom of Bahrain Vision 2030 available at http://www.bahrainedb.com/en/about/Pages/economic%20vision%202030.aspx#.V4DTPPl97IU; Kingdom of Saudi Arabia Vision 2030 available at http://vision2030.gov.sa/en; United Arab Emirates Vision 2021 available at https://www.vision2021.ae/en; Qatar Vision 2030 available at http://www.qdb.qa/English/Investing/Pages/Qatar2030.aspx; Oman Vision 2020 available at http://sfzco.com/en/salalah/about-oman/vision-2020; Kuwait Vision 2035 available at http://www.da.gov.kw/eng/festival/vision_his_highness.php (Accessed on 7 July, 2016).

[17] On this point, see the visions published by each GCC country, cit.

[18] Cfr. Artt. 21 and 22 of the Agreement.

[19] Cfr. Art. 4 of the Agreement.

[20] Cfr. Art. 3 of the Agreement.

[21] Cfr. Art. 6, point 7, of the Agreement.

for payments in the single currency area"[22]. However right now the regulation in the sector is left to the national legislations, and there is no common ground for building up a legal framework at GCC Level.

Indeed a broad overview on the payments and security settlement systems in the Middle East Region reveals that the Arab regulatory asset is one of the weakest in the World, and that the majority of the concerned countries rely mostly on cash and cheque to initiate all large value payments, circumstance that makes difficult the achievement of efficiency and risk control. Additionally, it is clear the absence in the Region of specialized agencies and supervisory bodies, and even in the cases in which the central bank is the authority entrusted with the power to supervise the payments, its activities target only the efficiency and reliability, without considering the ancillary set of issues strictly related to a payment system, such as the promotion of competition in the relevant market and the protection of consumer interests[23].

Nevertheless, due to the stall in the single currency project, the establishment of a 'Pan-Arab Single Payment Area' might constitute the only chance to bring the banking sector to a new common starting point, by encouraging the equal treatment -in terms of costs and time- for cross-border and domestic payments, and by promoting the modernization of funds and securities transfers, with the final goal of relaunching the creation of an effective internal market in the Gulf.

For this to take effect a minimum legal framework is required and, due to a lack of precedent legislative measures in the neighborhood, the best example to follow is undoubtedly the European payment system regulation, culminated with the recently adopted directive on the payment services, which sets novel common standards for payment transactions and instruments[24].

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[22] Cfr. Art. 14, point 4, of the Agreement.

[23] For a detailed analysis on the topic, cfr. M. CIRASINO, M. NICOLI' (2010), *Payment and Securities Settlement Systems in the Middle East and North Africa*, World Bank. On the integration in the financial sector in GCC, see R. ESPINOZA, A. PRASAD, O. WILLIAMS (2011), *Regional Financial Integration in the GCC*, *Emerging Markets Review*, Vol. 12 No. 4, pg. 354. For a comparison with the European Union experience, see Banks for International Settlements (2014), *Report on Payments, Clearing and Settlement Systems in the Euro Area*, *https://www.bis.org/cpmi/paysys/ecbcomp.pdf* (accessed on July 9, 2016).

[24] Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC, in the G.U.E.U. L 337/35 of 23/12/2015. For an overview on the directive, see J. GORKA (2016.), *Transforming Payment Systems in Europe*, Springer; *M. CORTET-T. RIJKS-S.N. INNOPAY (2016), PSD2: The digital transformation accelerator for banks*, *Journal of Payments Strategy & Systems*, pg. 13; S. CARBÓ-VALVERDE-C.M. KAHN (2016), *Payment systems in the US and in Europe*, *Banco de Espana, Revista de estabilidad financiera*, Vol. 30, pg. 11. On the historical development of the Single European Payment Area (SEPA), see among others R. BOLLEN (2007), *A Review of Recent Developments in European Payment System Regulation (Including the Proposed Payment Services Directive)*, *Journal of International Banking Law and Regulation*, pg. 532.

The enforcement of legislations for cross-border payments and the identification of improvement measures capable to foster safety, efficiency and integrity, and to regulate governance and risk management in a strategic regional block like the GCC, can be reasonably the right path to pursue in order to enhance economic integration and interdependence in the Gulf legal systems. In fact, the cooperation among regulators is an essential component of the payment infrastructure and the oversight function, especially in the attempt of drawing foreign investors into a legal and safety regulatory environment. However, since this field is still underdeveloped in the concerned States, the only feasible solution for the time being seems to be the negotiation of banking arrangements between the countries involved, strategy that can lead to a costly and convenient mechanism for customers and business activities.

5. Pave the Way: GCC and European Union Compared

The introduction in the GCC of common regulations for the monetary, banking, and fiscal sector can be described as an epic tale characterized by a huge delay in establishing the monetary union, and in putting into circulation the single currency, more than once proclaimed as driving change by the local leaders. Such kind of economic process is not new in territories close to the Arab Gulf, since in other regional areas, namely Africa and East Asia, comparable plans have been developed. In any case the European Union represents without a doubt the principal model to look at in deciding the route to take for a revamp, due to the advancement in its implementation.

On the basis of all the above considerations and in light of the lively debate showed up in Europe in the aftermath of the widespread ‘Brexit’ phenomenon, it is worthy to raise some questions: Is the harmonization still a feasible and profitable project for the GCC countries? Is the unity a great chance or rather a deadly weapon for these countries?

A joint starting point for any reasoning in this matter is that the Cooperation Council is already in a monetary union with the US dollar since the decision taken by the local governments to peg their currencies to the American money system, and is exposed to the potential losses connected to the frequent inflation of the dollar. Consequently, one of main arguments in favor of the unification is the urgent necessity to reduce the dependence of the Gulf from the incomes of third parties, and to decrease the impact of foreign economic shocks on its wealth.

Among the other supporting reasons it should be included the high degree of homogeneity of the GCC Members in all respects, such as the religious, cultural and linguistic linkages; the similarity of social conditions; the commonality of regulations; and the nature of the contemporary economic challenges, with particular reference to the circumstance that the GDP heavily derives form

hydrocarbon-related activities and from the international trade. Most importantly, the increase in the bargaining power with the major economic blocks and the attraction in the local market of more import and export activities, which will follow from a full economic integration, represent the landing place of the shared ambition pursued in the last 35 years in the Arabian Peninsula.

Until now a mixture of economic and political factors has obstructed the realization of the unique monetary scheme. The fear of losing the autonomy over monetary and fiscal policies, and of surrendering a portion of the sovereignty to centralize supra-national entities authorized to make decisions in case of disputes are surely the main causes of the past failure. Therefore it is licit to ask: What is next?

In the described scenario the only key to success is the will of the regional leaders. The will to finally chase the harmonization in the economic and financial affairs enumerated in all the objectives and goals of the agreements in force, and the will to put effectively into effects the GCC economic action process that is still only on paper, by firstly building strong institutional bodies like a Central Bank, which should formulate and implement monetary and banking measures. The reference is already available and at least two motives argue in support of paving the way towards the European model: the establishment of both regional alliances for a similar exigency, that is the security, and a shared vision clustered around the protection of four main freedoms in their respective internal economic spaces.

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BITCOIN AS CASH IN TERMS OF THE EUROPEAN ANTI-MONEY LAUNDERING DIRECTIVE

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The European Anti-Money Laundering Directive 2015/849 sets out detailed rules for the prevention of money laundering and terrorist financing. It presents a clear framework for financial institutions, covering both cash and electronic payments systems. However, the directive fails to regulate digital currencies, such as bitcoin, leaving a large lacuna in the directive. Financial institutions specializing in digital currencies are thus left to their own devices with little information about how best to address the obligations set forth in directive 2015/849. In this paper, the author will propose the application of the rules on cash to digital currencies. As digital currencies are limited to the digital sphere and operate in a closed environment, they are often mistakenly compared to e-money, but the way digital currencies operate is in fact very close to how cash is used today. Digital currencies are obtained through online exchanges, just as cash is usually obtained from an (automatic) bank teller. Cash and digital currencies are both typically exchanged between individuals without interference of a third party. Finally, there is no entity who can be obliged to track the movement of cash or digital currencies between individuals, except if a payment is exceptionally large. However, unlike anonymous cash, there exists a ledger of all transactions carried out in digital currencies, which can be used by financial intelligence units directly to track suspicious movements. Therefore, it can be argued that the application of the rules on cash could facilitate a smooth incorporation of digital currencies into the existing framework.

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1. Introduction

Any new technical development challenges the legal framework existing at the time it is conceived, by very simply not fitting into the existing categories to which the law applies. The internet itself is a good example of a technical development which challenged and forced many amendments into the legal framework in order to envelop the new development and its consequences. This development is still ongoing, as slowly the digital world reaches into more and more areas of the physical world, and as the two become more and more intertwined. One aspect of such an ongoing development is the inclusion of virtual currencies into the existing legal framework concerning financial transactions, and in particular the anti-money laundering rules.

In some areas of daily life, technology has almost completely replaced any older analogue way of doing things. In other areas, this development is much slower. Examples for both can be found in financial transactions. Online banking is ubiquitous, and private online banking is now the favoured way to carry out one's transactions, as it is more convenient for both businesses and consumers than going to a bank at its physical location and filling in a slip of paper. In fact, small branches of banks are being closed in response to this development, which again hurries the transition along. The increased efficiency, economy, and convenience of online banking has allowed for a nearly frictionless transition in society and swift amendments to the law, which accommodates this development. Other developments have not run as smoothly. One example for a more difficult transition is virtual currencies, and one of the legal frameworks which cause problems in this transition is the Anti-Money Laundering directive 2015/849.

The newest European Anti-Money Laundering directive was just passed in 2015, at a time when virtual currencies had already gained a large user base and significant levels of attention of the general public. Especially the blockchain technology, first introduced by virtual currencies, has entered computer sciences with much commotion. However, despite all the current interest in virtual currencies, the Anti-Money Laundering directive does not accommodate virtual currencies in the framework. In fact, the directive does not mention virtual currencies at all, and continues to cater exclusively to traditional, and for the most part analogue, financial service providers.[1]

This paper thus seeks to answer the question of how to make this new phenomenon of virtual currencies fit into categories designed without so much as the proverbial nod to this particular technology. The best option, with regard

[1] The preparatory documents do mention the importance of keeping on top of technological developments which may be used for the purposes of money laundering or terrorist financing. See European Commission, Proposal for a Directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing. COM (2013)45 final, 4.

to the unique characteristics of virtual currencies, appears to be to apply the rules on cash transactions to virtual currencies This not quite obvious but no less fitting analogy should create legal certainty for all businesses obliged to follow anti-money laundering rules under the directive, while at the same time creating minimal obstacles for the development of virtual currencies as an emerging technology.

The discussion of this idea is started by a short explanation of what virtual currencies are, and a summary of the existing anti-money laundering framework of directive 2015/849. Following this basic outline of the facts, the paper shall turn to the characteristics of cash and virtual currencies, in particular the anonymity of cash, and the enhanced privacy of virtual currencies, and finally outline the main advantages and disadvantages of fitting both instruments into the same category.

2. Virtual Currencies

As has already been mentioned, virtual currencies are an entirely new phenomenon on the financial marketplace. While the idea and demand had been around for a long time, several technical difficulties remained, until in 2008, Satoshi Nakamoto proposed a decentralized virtual currency based on a peer-to-peer network.[2] After a little more tweaking on the code, Nakamoto and a handful of early enthusiasts introduced Bitcoin early in 2009. Since the successful start of Bitcoin, many other virtual currencies have been launched, some with great success.

Virtual currencies are a completely new form of financial tools. Bitcoin, the first and most successful virtual currency in existence, is both a system and the name of the unit of account used on this system. To distinguish the two, the system is spelled with a capital B, while the unit of account is not capitalized. The system is the revolutionary element. Fiat currency depends on a government establishing that currency, coining it, and establishing a central bank to implement its financial policy.

Virtual currencies are different from the fiat currency system in several ways. The virtual currency environment is not established by a government, and most virtual currencies have no ties to any official government body of any country. Instead, they are based on a peer-to-peer system, administered and run by private individuals and businesses, which may be strewn all over the world, who use their computer power to keep the system running, but who cannot be considered employees or even managers of the virtual currency. The independence of physical location and geographical ties, and the absence of staff

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[2] See: S. NAKAMOTO (2008), *Bitcoin: A Peer-to-Peer Electronic Cash System*. To be found at https://bitcoin.org/bitcoin.pdf (last accessed 12 October 2016).

and official representatives also protects a virtual currency environment from government interference. There is no official physical representation of any virtual currency, such as coins and banknotes. Instead, every transaction takes place purely online.

Finally, and perhaps most importantly, the peer-to-peer system does away with the importance of a central bank to administer transactions.[3] Instead, a ledger is compiled, containing all transactions ever having taken place on the system. This ledger is accessible to all users of the system. This way, when a transaction is proposed, a user can go back through the transaction history to determine whether the counterparty is in possession of the necessary amount of virtual currency for the transaction. All transactions transferring units to the user as well as all transactions of the user spending units are chronicled in the ledger, making it easy to compute the exact amount of units in the possession of any given user at any given time. Since every user is in possession of the whole ledger, a transaction attempting to spend more units than the user has in possession is rejected by the system and cannot be completed.

This final point makes the virtual currency system secure without the need for a central authority. The enduring problem prohibiting an earlier spread of virtual currencies was the so-called double spending problem. In a cash transaction, the physical coins and banknotes leave the possession of one person and pass into the possession of another person, when a transaction is completed. Electronic transactions of fiat currencies are administered by banks, who have access to a person's balance and can therefore reject a transaction when sufficient funds are lacking, or accept a transaction and grant the customer credit.

This is different in virtual currencies. Computer systems make it possible to manufacture almost infinite numbers of copies of any computer file. A file stored on one user's computer can be copied and sent to an infinite amount of other users, while the original file remains on the first user's computer. This is an obvious problem in financial transactions, as any system in which units could be copied and transferred more than once would surely be doomed. Before Bitcoin, there was no reliable way to make a unit unique in such a way, that a user could only spend it once, rather than copying it to use the same unit again in another transaction. The only secure way to ensure the validity of transactions was the existence of a central authority keeping track of all transactions to exclude the possibility that a unit was spent twice. The virtual currency environments allow every member of a peer-to-peer network access to this ledger, thereby replacing the central authority with the sum of other users of the system.

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[3] S. NAKAMOTO (2008), *Bitcoin: A Peer-to-Peer Electronic Cash System*. 1.

3. The Anti-Money Laundering directive

In May 2015, the fourth European Anti-Money Laundering directive was passed and adopted. Directive 2015/849 is a powerful tool in the fight against money laundering and terrorist financing, introducing far-reaching surveillance of financial transactions and strong safeguards to be taken by all businesses offering financial transactions services.

The rules circumscribe a regime of due diligence, in which each customer must be identified before a financial transaction is carried out, and where every financial transaction itself must be scrutinized and monitored, in order to make sure that transactions which raise a suspicion of money laundering or terrorist financing are, if possible, not carried out, and in all cases communicated to the financial intelligence unit, which specializes in the investigation into terrorist financing and money laundering.

The directive applies to all obliged parties enumerated in article 2 (1). This includes banks, insurances and investment firms, but also tax accountants, lawyers, and estate agents. All those entities have in common that they deal with large amounts of money on a professional basis. The only exception is the inclusion of traders in (luxury) goods, who must comply with the obligations of the anti-money laundering framework whenever they accept a cash payment of EUR 10 000 or more (article 11).

The obligations of these parties are twofold. In the first place, there are customer due diligence duties, which comprise the identification of all customers (article 13 (1) (a)). In the case where the customer is a legal person, the beneficial owner must be ascertained, i.e., the corporate structure must be examined and followed, until "any natural person(s) who ultimately owns or controls the customer and/or the natural person(s) on whose behalf a transaction or activity is being conducted", is found (article 13 (1) (b) jo. Article 3 (6)). Furthermore, the transaction carried out by the customer must be scrutinized, to exclude as far as possible the risk of money laundering and terrorist financing. If the customer and the obliged entity enter into a business relationship of longer duration, each transaction carried out during this business relationship must be monitored and scrutinized when it is carried out (article 13 (1) (d)).

In the second place, there are the reporting obligations. If one of the transactions of a customer raises a suspicion of money laundering or terrorist financing, the obliged entity must report this transaction to the financial intelligence unit (article 33). The financial intelligence unit must be provided with the full information record about the customer and the suspicious transaction. In addition, the financial intelligence unit has access to unspecified information collected by other government agencies (article 32 (4)). The customer is not to be informed of a report sent by the obliged entity to the financial intelligence unit (article 39).

Before continuing to virtual currencies, it should be pointed out that the anti-money laundering directive does not in fact speak of "money", but rather of "property", which term is defined in article 3 (3) as "assets of any kind, whether corporeal or incorporeal, movable or immovable, tangible or intangible, and legal documents or instruments in any form including electronic or digital, evidencing title to or an interest in such assets". This extremely broad definition of property very clearly also covers virtual currencies as possible property used for the purposes of money laundering or terrorist financing.[4]

4. The anonymity of cash and the privacy of virtual currency systems

Cash is an anonymous means of financial transfers.[5] In a great majority of transactions, cash is exchanged between two persons who will not be known to one another. For instance, a five euro bill may be used by a customer to buy a small item from a supermarket. The cashier may routinely check the genuineness of the banknote, but if the note is genuine, there will be no reason to identify the customer. This same banknote may be handed to another customer as change in a following transaction. This customer will not know who the previous owner of that note was. When the bill is next spent, the customer will likely have forgotten where and when exactly he has received it. These details are not recorded nor remembered or attended to, because the transaction is completed when the physical banknote or coins have changed hands, and because the identity of the banknote or coin is not of the essence; it is the value of the notes or coins which is of interest to the parties.

While bank notes are marked by unique serial numbers, these numbers are highly impracticable to be tracked by any other party than an established bank. An average banknote of a small denomination will travel through many hands before it is turned back to a bank, and none of the parties by whom it is used for a transaction will typically have noted the serial number.

This is different in electronic transfers. If the customer of the supermarket in the example paid his purchases by card, this transaction is very minutely recorded. The trail left by this transaction would include the identities of both parties, i.e. their names and bank account numbers, the exact time that the

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[4] C. KAISER (2016), *The Classification of Virtual Currencies and Mobile Payments in Terms of the Old and New European Anti-Money Laundering Frameworks*, in G. GIMIGLIANO (ed.), *Bitcoin and Mobile Payments, Constructing a European Union Framework*, Palgrave Studies in Financial Services Technology, 212 f.

[5] See: Financial Action Task Force (FATF), FATF Report: Money Laundering through the Physical Transportation of Cash (October 2015). To be found at http://www.fatf-gafi.org/media/fatf/documents/reports/money-laundering-through-transportation-cash.pdf (last accessed 13 October 2016), 27 ff, 31 f. for very detailed information on the anonymity of cash and the problems created by this anonymity.

transfer was made, and the amount transferred. Furthermore, this record would be accessible to both parties to the transaction as well as the intermediaries, i.e. their banks or credit card companies.

The anti-money laundering directive only attempts to break into the anonymity of cash transactions when a high threshold is reached. Article 11 of directive 2015/849 sets the threshold at which persons trading in goods must apply customer due diligence measures at EUR 10 000. Such a threshold therefore only concerns sellers of luxury goods, and even for such traders, large cash transactions are no longer very common. Electronic transactions, on the other hand, trigger the whole range of obligations upon the financial intermediary. Referring again to the example above, the two parties are fully identified to their respective banks, and an identity record is transferred in the transaction details. Furthermore, such a transaction will be scanned for possible red flags, pointing to possible terrorist financing or money laundering operations. While the transaction in this example is not likely to raise a red flag, reporting duties may follow if it did.

Therefore, cash and electronic transactions mark the two extremes of identification. In cash transactions, no records are retained, and the transaction is generally completely anonymous. In electronic transactions, the parties are fully identifiable by the trails left through the transactions.

Virtual currencies are unchartered territory somewhere between those two extremes. Virtual currencies are also often erroneously called "anonymous", in fact, the belief that virtual currencies are anonymous is probably the most wide-spread misconception about the system. Instead of anonymity, pseudonymity should be spoken of in this context. Each transaction made via a virtual currency system is recorded in the blockchain. As has already been shown, the blockchain is a publicly accessible record of all transactions, from which any user of the system can verify that the counterparty is in possession of sufficient funds to complete the transaction. It records the sender and recipient of each transaction, as well as an exact time-stamp, and the amount transferred. The sender and recipient are denominated by their public key, which acts as a pseudonym for the person behind the transaction. The fact that each transaction is recorded in the blockchain thus clearly eliminates the anonymity of virtual currencies as compared to cash.

5. Virtual currencies in the Anti-Money Laundering directive

When moving from the legal provisions in the anti-money laundering directive to virtual currencies, many commentators make the mistake of comparing transactions using virtual currencies to digital transactions carried out by banks or credit card companies. Surely they look similar at first glance, as

in both instances, value is moved between two accounts electronically. However, the two systems are manifestly different.

The bank or credit card company is, in the first place, a legal person, falling under the categories of obliged entities in the Anti-Money Laundering directive. As such, these financial services providers certainly have an interest in following the law, and could be compelled to follow it were they not so inclined. Any such obliged party will have physical offices and employees which could be searched or questioned by law enforcement entities, and a reputation and business interests which it will want to protect from the financial drawbacks and negative press involved in being suspected of non-compliance with the law, searched, or fined for violations. A virtual currency environment, on the other hand, is in most cases a loosely connected network of users who run the same code on their computer. There may be legal persons among them, but in a peer-to-peer network, not one of the nodes can be said to control the network. Besides the lack of a legal status, there are generally no official representatives, no offices, and what members there are to the system may be physically located in dozens of different jurisdictions, thereby effectively removed from the grasp of law enforcement agencies in any single jurisdiction. Therefore, a bank or credit card company can be obliged to comply with the anti-money laundering legislation, while a virtual currency system can not.

In the second place, electronic transactions using a bank pass or credit card always run through intermediaries. When a customer initiates a transaction using his bank pass, the transaction is in the first instance between him and his bank. The bank clears the transaction, communicates with the bank of the other party, and that bank sees to the funds being placed in the account of the counterparty. The transaction thus depends on the work of at least one, but often two or more intermediaries. This is not the case in virtual currencies. In transactions using virtual currencies, the users communicate directly with one another. Surely, transactions are still cleared by the system, and many nodes in the peer to peer system are involved in confirming the transaction, but in principle, the funds move straight from one user to another without any stopovers.

Only very few services connected to a virtual currency environment are covered by the Anti-Money Laundering directive.[6] The main entrance- and exit points of virtual currency systems are guarded and monitored for the purposes of the anti-money laundering directive. Most users of virtual currency systems enter the environment through an exchange. There are many online exchange businesses for virtual currencies, which work in the same way as analogue currency exchanges, in that the users send a certain amount of fiat currency to

[6] See C. RÜCKERT (2016), *Virtual Currencies and Human Rights*, 16 f.. To be found at http://ssrn.com/abstract=2820634 (last accessed 13 October 2016).

the exchange by credit card or other electronic means, and receive the equivalent amount of virtual currency in exchange.

Those businesses, if they are established within the European Union, are obliged parties under the European Anti-Money Laundering framework and must comply with the stipulations of the directive.[7] Another example of a service which should be covered by the anti-money laundering rules are gambling services using virtual currencies for their business.[8]

The problem with the anti-money laundering directive is thus that any transaction involving an obliged party is heavily regulated, obliging the financial services provider to identify its customers, monitor transactions, and report transactions if necessary. At the same time and parallel to this heavily regulated sector of financial transactions exist the virtual currency environments, to which, with very few exceptions, all those rules do not apply.

6. A proposal for a solution: the parallel with cash transactions

The previous section was concerned with eliminating the erroneous comparison of virtual currencies to other means of electronic transactions. Instead of comparing virtual currency transactions to electronic bank transfers, then, there is the somewhat less obvious but very fitting comparison with cash transactions.

There is one significant similarity between cash transactions and virtual currency transactions. Both transactions can be accomplished without any intermediaries. In cash transactions, the transaction is completed with the passing of the physical bank notes or coins from the hands of one party to those of another. No intermediaries are needed to clear or process the transaction, and often transactions are concluded between consumers. The simple impracticability or even impossibility of applying the rules stipulated in the directive thus created a special status for cash transactions. They are not monitored at all, unless the value of the transaction reaches the EUR 10 000 threshold.

It has already been shown that virtual currencies and cash transactions work in much the same way. The transaction is completed with the passing of virtual currency units, such as bitcoin, from the account of one user to another. There is no central intermediary needed to process or complete the transaction. The transaction is included in the blockchain, which is administered via a peer to peer system by other users, but these third parties ("miners") by no means

[7] C. KAISER (2016), *The Classification of Virtual Currencies,* 214 f.

[8] One important improvement to the fourth Anti-Money Laundering directive as compared to the previous directive 2005/60/EC is that while the previous framework only covered analogue, brick-and-mortar casinos, directive 2015/849 also covers online gambling services. See C. KAISER (2016), *The Classification of Virtual Currencies*, 218 f.

inhibit such a position as a central clearing agency would, as they exist in bank or credit card transfers.

The fact that there is no central intermediary also makes the entire framework impossible to be applied to virtual currency. There is simply no obliged party to identify parties and monitor transactions. Consequently, virtual currencies in so far fall to a large extent outside the scope of the anti-money laundering directive. Therefore, the same obstacle which prevents cash transactions to be monitored on a grand scale also prevents virtual currencies from being monitored effectively. The idea to treat two different instruments which share the same difficulty for a legislator in the same way is surely not too far-fetched.

7. Consequences of applying the rules on cash transactions to virtual currencies

Surely, proponents of a strong anti-money laundering framework will not like to see the equal treatment of virtual currencies and cash. From the point of view of advocates of a strong stand against money laundering, electronic financial transfers as offered by banks and credit card institutions create perfect conditions. Those electronic transfers contain lots of information about each transaction, such as the amount transferred, the time stamp, but also information about the sender and recipient of the funds. Full identification records about both parties to each transaction are available at the banks. And finally, and this is certainly one of the most attractive points of the anti-money laundering framework, all of the identification and monitoring duties, including the financial burden that they create, are shifted on to the financial services provider. The significant costs of such identification duties and the ongoing monitoring are thus carried by the financial services providers, and, needless to say, ultimately by their customers, who are the subjects of this monitoring.

Cash, as has been shown, is wholly anonymous. Anti-money laundering duties can only apply to transactions of an amount equal to or higher than EUR 10 000. The very large majority of cash transactions are thus not monitored at all. Clearly, this makes cash one of the most attractive vehicles for money laundering operations.[9]

The rule, that all transactions beyond EUR 10 000 in cash do fall under the anti-money laundering framework certainly would have to be applied to virtual currencies as well. All traders in goods accepting virtual currencies as payment would be obliged to identify the customer and monitor, perhaps report the transaction depending on the circumstances, if the value of the transaction

[9] FATF Report, *Money Laundering through the Physical Transportation of Cash*, 27 ff, 31 f. for detailed figures.

would exceed the equivalent of EUR 10 000 in the virtual currency unit of account.

A problem which presents itself is that the level of protection against money laundering and terrorist financing in virtual currencies will not be very high if the rules on cash are applied to it. However, if this lower level of protection is deemed acceptable in cash transactions, it should also be accepted for transactions in virtual currencies. The level of risk of abuse of cash is very likely higher than that of virtual currencies. In the first place, cash is the preferred option for money laundering and terrorist financing operations. This has not changed significantly since virtual currencies have established themselves in the market place.

The conversion of virtual currencies into fiat currency can be a complicated calculation. Virtual currencies are notoriously unstable, the exchange rate can sore and plummet over great margins within a short time. This difficulty can only be overcome by exact time stamps, and the threshold for consumer due diligence obligations should therefore also only apply to transactions exceeding the equivalent of EUR 10 000 at the exact time at which the transaction was completed, disregarding the development of the exchange rate before and after the transaction. This is a problem which any trader or service provider whose transactions cross the border of the Eurozone is already familiar with, as the exchange rate of other fiat currencies will certainly also vary over time, though perhaps not as drastically as that of virtual currencies.

Furthermore, while virtual currency systems thus elude the reach of the anti-money laundering framework, the users of the virtual currency environment are not wholly beyond the reach of the anti-money laundering rules.[10] The widespread use of exchanges in order to enter and exit the virtual currency environment has already been mentioned. Certainly those exchanges can be classified as financial institutions and therefore as obliged parties.[11] All online exchanges operating under the law of any member state of the European Union therefore are bound by the national law implementing the European anti-money laundering framework. Many already do.[12]

Similarly, gambling services, which make up a large part of the traffic in virtual currencies, are obliged under the anti-money laundering framework and thus must comply with the obligations set out therein.

Finally, despite the similarities between how cash and virtual currencies work, there is one great difference between the two. While cash is wholly anonymous, all transactions carried out in virtual currency environments are listed in the publicly accessible blockchain. Therefore, although there is no

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[10] C. RÜCKERT (2016), *Virtual Currencies and Human Rights*, 12.

[11] C. RÜCKERT (2016), *Virtual Currencies and Human Rights*, 10 f.

[12] See, for instance, the policies of Bitfinex at https://www.bitfinex.com/terms and https://www.bitfinex.com/privacy (last accessed Oct. 12th, 2016). Similar terms of service and policies are applied by all the major exchange services.

entity which can be obliged to monitor all transactions carried out in virtual currencies, law enforcement can well monitor the blockchain itself. Virtual currencies are therefore by no means anonymous, nor do they allow as ample opportunities for criminal transactions as does cash.

8. Conclusion

To go back to what was said in the start, almost all new technologies put significant problems before the legislator when the existing legal framework must be amended to accommodate the new development. Also, many emerging technologies have been demonized as vehicles for crime. The world wide web is a good example for both, and has not yet left either of those problems behind itself.

Virtual currencies are still in an early stage of development and public acceptance. The European legislator now carries a significant burden of responsibility to regulate virtual currencies sensibly, in order to both address the risk which virtual currencies undoubtedly bring with them, but at the same time, legal regulation of the technology must not stifle its development. This paper was intended to start a discussion on how such a sensible regulation may be begun.

To sum up, it could be argued that some sensible regulation within the framework of the existing laws would be better than legal uncertainty and fragmentation of regulation if member states themselves fill in the lacuna left by the directive. As virtual currencies are necessarily rooted in an online context, the services provided utilizing virtual currencies also take place on the internet, which means that there is a high level of cross-border transactions. Different regulation of virtual currencies therefore would work to the detriment of the development of this technology. Therefore, the European level should be the preferred arena for the development of a framework regulating virtual currencies in the context of money laundering and terrorist financing, and in all other areas as well.

TWO-SIDED MARKETS AND CARD PAYMENT SYSTEMS: NEW APPROACHES AND TRENDS UNDER ART. 101 TFEU

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The paper aims at providing a thorough overview of the special nature of card payment systems that are a well-known example of two-sided markets. Indeed, card payment systems are an instance of two-sided market because they serve two different groups of customers or end-users (i.e. cardholders and merchants) with a joint demand, and they present network externalities in terms of the interconnected role exercised by end-users on those markets, so that the more cardholders there are the more they make the card payment system valuable for merchants, and the other way around. Therefore, the specific nature of card payment systems constitutes the ground for the analysis of two recent decisions in competition law, namely the case of Groupement des Cartes Bancaires and the case of MasterCard I. The legal and economic reflections that are raised in this paper aim, therefore, to illustrate the interconnections and commonalities between these two cases in terms of constructing and providing a possible definition of two-sided markets under article 101 TFEU.

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To Marie

1. Introduction

This paper aims at providing a thorough overview of the special nature of card payment systems that are a well-known example of two-sided markets. To this end, two-sided markets are especially analysed from the perspective of competition law in order to suggest how the European Commission and national competition authorities should construct the market definition of two-sided markets in order to assess anti-competitive agreements under article 101 of the Treaty on the Functioning of the European Union (TFEU).

In paragraph 2 after examining and trying to provide a specific definition of two-sided markets from a competition point of view, the paper illustrates two competition cases (paragraphs 3 and 4) in order to show how the features of two-sided markets can effectively influence the interpretation and, therefore, the application of article 101 TFEU. Ultimately, the legal analysis of the judgements aims at discovering common elements of understanding capable of providing useful interpretation guidelines to assess anti-competitive agreements in relation to two-sided markets.

Indeed, in September 2014 the Court of Justice of the European Union (CJEU) upheld the decision of two major cases, namely *Groupement des Cartes Bancaires* v Commission[1] and MasterCard v Commission (the so called MasterCard I)[2]. The first case shows, *inter alia*, that under law the market definition of a two-sided market is not necessarily connected to the existence of a virtual platform or in general to a platform tool. Indeed, as it is further explained in paragraph 2 of this paper two-sided markets can be identified by at least three principal features under a competition law analysis (namely, indirect network effects, price structure of the market and the diffusion factor), so that the simple legal agreement to set up a network and the determination of the price structure of the network in accordance to that agreement is sufficient to potentially affect the utility of consumers as well as operators of the network. In other words, the agreement can be anti-competitive. On the other hand, the case of MasterCard I is centred on the price structure of two-sided markets in relation to the imposition of multilateral interchange fees and its possibility of being justified through the pursuing of network externalities under the balancing test of article 101, paragraph 3 of the TFEU. It is argued that according to the MasterCard I case the efficiency exemption under article 101 (3) TFEU cannot be invoked in relation to two-sided markets. Indeed, objective advantages in the CJEU's view cannot be limited to one market side but shall occur on all market sides. This circumstance shows the interconnection of two-sided markets, their functioning through network

[1] *Groupement des Cartes Bancaires* v Commission, C-67/13 P, EC:C:2014:2204.

[2] MasterCard and Others v Commission (Case C-382/2012).

externalities and at the same time differentiate them from one-side markets. Finally, consolidating arguments are exposed in the conclusions.

2. Card payment systems and the two-sided market nature

There is not an agreed definition of two-sided markets[3]. In particular the various definitions of two-sided markets are usually trying to move beyond the approach that "you know a two-sided market when you see it"[4], namely they are more centred on studying the dynamic-functioning of two-sided markets instead of focusing on their mere structure. Indeed, the lack of an agreed definition is reflected also into the inconsistent terminology that is used in respect of two-sided markets (such as, platform industries, multisided platforms, etc.).

It seems that the simple acknowledgment that every market can be defined as two-sided, since any transaction requires the existence of at least two or more parties (for instance, a buyer and a seller or a landlord and a tenant) broaden the scope of the research. Therefore, to narrow this scope it is necessary to highlight that the simple interaction between two or more parties is not a sufficient requirement in order to define a market as two-sided. As well, the usage of a platform tool to link agents of different markets does not seem to be the principal feature of every two-sided or multi-sided market(s)[5]. These – as it will be further explained – are mere ancillary features at least from a competition point of view.

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[3] Organization for Economic Co-operation and Development (OECD), *Two-sided Markets Report*, 11, 2009, available at <https://www.oecd.org/daf/competition/44445730.pdf>; CHAKRAVORTI, ROSON, *Platform Competition in Two-sided markets: the case of payment networks*, Federal Reserve Bank of Chicago Working Paper 2004-09, 2.

HAGIU, WRIGHT, *Multisided Platform, Harvard Business School Working Paper*, 15-037, 4, 2015, available at <http://www.hbs.edu/faculty/Publication%20Files/15-037_cb5afe51-6150-4be9-ace2-39c6a8ace6d4.pdf>.

[4] This approach is introduced in the seminal paper of Rochet and Tirole (see ROCHET, TIROLE, *Two-sided Markets: A Progress Report*, 37 *RAND Journal Economics*, 2006, 645).

[5] EVANS, SCHMALENSEE, *The Industrial Organization of Markets with Two-Sided Platforms*, in *Competition Policy International*, 3, 1, 151. They propose a practical definition of two-sided or multi-sided markets through the existence of a platform that is the means of interconnection of different parties or agents. Nonetheless, this practical definition can be well imagined in the case of mobile payments such as the mobile digital wallet where a virtual platform consent different parties, namely merchants and customers in addition to advertisers and banks to join a network and sharing positive network effects through the common usage of a virtual device. To this end, is possible to think also to the e-commerce platforms and academic journals' platforms and so on. On the other hand, the virtual platform or simply a sort of platform tool can also be absent such as in some cases of payment card systems when the nature of two-sided market is only determined by the simple interaction between merchants and cardholders and between their banks who join a payment system created by banks' association that does not work necessarily by virtue of virtual platforms, but only by means of contractual agreements. Hence, other characteristics will be vital in order to determine the two-sided market structure such as the price structure and consumer utility at least from a competition point of view.

To this end, the real key element that two-sided markets share is their possibility to create network externalities or to better produce network effects, namely the discourse is centred on the well-known theory of network externalities[6]. According to the latter, network externalities are produced when the utility of a consumer in a certain market depends on the number of consumers of the same good or service.

Nonetheless, two-sided markets are markets with a special type of network externality, namely they produce indirect network effects. In particular, this externality does not depend on the number of agents in the same class (the number of consumers of a same product or service), but on the number of different and compatible agents on an opposite market side. For instance, the well-known example of a two-sided market is the card payment system. Here the issuers of credit cards are willing to issue them if there are merchants that are willing to accept them. In the same fashion, the cardholder, namely the consumers of the issuing side are willing to buy credit cards (*i.e.* usage cost) if there is a high number of merchants accepting the card for payment (*i.e.* diffusion). Indeed, in a two-sided market there is always a connection between costs and diffusion (namely, no cardholder would be interested in purchasing a cheap credit card if no merchant is willing to accept it).

Therefore, two-sided markets do not depend only on price, but also on diffusion. They are an instance of indirect network effects. In addition, the prices that are charged on both markets determine also the diffusion factor. Therefore, in relation to card payment systems a good balance of the price structure of the markets and the preservation of positive network externalities are vital to guarantee the two-sided functioning of the markets and at the same time to indirectly protect the utility of consumers or end-users.

Summing up in relation to two-sided markets, it seems that at least three main features can be pointed out, showing that two-sided markets are markets where the cumulative presence of the following elements are determinant factors:

- Network externalities or better indirect network externalities;
- Price structure of the market; and
- Diffusion factor that is dependent on the correct functioning of the first two elements.

The correct functioning of these features can make two-sided markets capable of maximizing consumer utility. Therefore, in the case of card payment systems the utility of cardholders and merchants. Specifically, network externalities are usually scrutinised by competition regulators and authorities in order to avoid potential market abuse of dominant position and guarantee that outside

[6] KATZ, SHAPIRO, *Network Externalities, Competition, and Compatibility,* in *American Economic Review*, 75, 1985, 424; FARRELL, SALONER, *Standardization, Compatibility and Innovation*, in *Rand Journal of Economics*, 16, 1985, 70. These are the principal authors who started to study network effects.

operators of the network are not discriminated or limited to join the set up network. This is particularly true in the case of mobile payment systems and digital mobile wallets[7]. On the other hand, this paper is more centred on studying the price structure of two-sided markets in order to assess how to avoid potential cartels or coordinated anti-competitive conducts that are likely to be carried out by network operators in order to protect consumers' interest. In the end, only by limiting these two possible anti-competitive behaviours, namely abuse of dominant position and cartels, the diffusion factor of the network can be affected and consequently the utility of consumers enhanced.

3. *Groupement des Cartes Bancaires*: the background

Groupement des Cartes Bancaires (the "Group") is a French inter-bank network; an association of undertakings governed by French law and created in 1984. It is composed of the main credit institutions operating in France, to manage and guarantee the interoperability of the payment system for bank card payments and withdrawals. Under this payment system, efficiencies have been created by network effects that connect issuing banks to acquiring banks. Indeed, the system enables the use of bank cards for payments issued by Group members (*i.e.* issuing side) to affiliated merchants and withdrawals from automatic teller machine (ATMs) controlled by any of the members of the Group (*i.e.* acquiring side). As explained in the paragraph above, card payment systems are an instance of two-sided market. Specifically, the two-sided market nature of such industry is capable of giving rise to economic considerations that lead to new legal considerations, which – as it will be explained below – constitute part of the consolidating arguments and interpretation guidelines concerning a new application of article 101 (1) TFEU[8] in relation to two-sided markets.

In particular, on the 10th of December 2002 the *Groupement des Cartes Bancaires* notified the European Commission, under Council Regulation n. 17/1962, a series of proposed new interchange fees that would be paid by the Group members when issuing cards or joining the group. Specifically, three pricing measures were advanced:

- A mechanism for regulating the acquiring function (the so called MERFA formula[9]) to determine the fees payable by card issuers in order to ensure that members that mainly issued cards (as compared to acquiring merchants and installing ATMs) would have paid higher fees;
- a change in the membership fee for the Group, namely in addition to a fixed

[7] The avoidance of market abuse of dominant position and the preservation of positive network externalities is particularly important in mobile payment solutions operated by virtue of digital mobile wallets. See D'ALVIA, *Mobile Payments and Merger Regulation: A Case Law Analysis*, in *Bitcoin and Mobile Payments: constructing a European Union Framework* (Gimigliano ed.), 251.

[8] See further paragraph 3.2 below.

[9] The acronym is for the French *Mécanisme de Régulation de la Fonction Acquéreur*.

sum of 50,000 Euro levied on membership, a further membership fee per card issued was established in the three years following the membership; and

- a fee for "dormant members" that were essentially members of the Group, which were inactive or not very active before the new pricing measures (the so called "wake up" fee).

The European Commission adopted two statements of objections in July 2004 (which later the European Commission withdrew) and July 2006 respectively. By which it concluded that the facts alleged were the expression of a secret anti-competitive agreement. By decision of 17 October 2007[10], the European Commission concluded that the object of the pricing measures was to limit competition between banks that entered into that agreement in terms of limiting the price reduction of bank cards, and to impede competition of new members (in particular, large retailers, online banks and foreign banks) by restricting their entrance to the market for the issue of payment cards in France. For these reasons, the European Commission required the Group to end immediately the infringement and to refrain from adopting any similar measure in the future.

The Group appealed such decision before the General Court for the annulment. In 2012 the General Court[11] dismissed the action due to the fact that the pricing measures contested by the European Commission effectively restricted competition due to their anti-competitive object. Indeed, the General Court found that it was not obliged to examine the effects of the pricing measures on the market. It was considered *sic et simpliciter* as an anti-competitive restriction by object.

Therefore, the Group brought a new appeal before the CJEU against the judgement of the General Court, and contested, *inter alia*, that the General Court had erred in law in the application of the concept of restriction of competition by object. Therefore, the following paragraph is dedicated to the examination of the decision of the Court of last instance.

3.1. The 2014 decision of the Court of Justice of the European Union

The appeal brought by the Group before the CJEU was based on three main legal grounds, namely:

- error in law in the application of the concept of restriction of competition by object;
- error in law in the application of the concept of restriction of competition by effect;
- failure of the General Court to make reference to the principle of proportionality in assessing the context of the pricing measures.

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[10] European Commission, decision C (2007) 5060 final of 17 October 2007 relating to a proceeding under Article [81 EC] (COMP/D1/138606 – *Groupement des cartes bancaires* 'CB').

[11] CB v Commission T-491/07, EU:T:2012:633.

Before examining the judgement of the CJEU it is useful to further explain the interpretation of article 101 (1) TFEU. Under article 101 (1) TFEU agreements, decisions and concerted practices are prohibited if their object or effect is to restrict, prevent or distort competition. When an agreement has an anti-competitive object, it is not necessary for the European Commission or national competition authority to assess also its anti-competitive effects. In other words, a restriction by object can be found only after it is shown that the agreement, by its wording, objectives and context[12], displays a sufficient degree of harm to competition, so that it is intended to change appreciably the structure of the market. For instance, a naked cartel or output limitations, and reductions in capacity are explicit agreements or practices that limit competition and effectively change the structure of the market. On the other hand, where anti-competitive behaviours do not reveal a sufficient degree of harm (*i.e.* by object restriction), the effects of the coordination must be considered and the European Commission or the national competition authorities have to show that competition has "in fact" been distorted to an appreciable extent (*i.e.* by effect restriction).

The decision of the CJEU in 2014[13] has been extremely important at least[14] to clarify certain aspects of its prior case law in relation to the concept of restriction of competition by object. Firstly, it has been outlined that a by object restriction does not have to be interpreted broadly, but it is necessary to adopt a restrictive interpretation of such concept. To this end, the CJEU distances itself from the expansive interpretation of previous cases decided by European Commission in relation to the notion of "by object" restrictions[15].

Secondly, it clarifies that the essential criterion to establish a restriction of competition by object is to establish whether an agreement (or decision or concerted practice) in itself reveals "a sufficient degree of harm to competition" (see paragraph 49) such that it can be regarded "by [its] very nature as being harmful to the proper functioning of normal competition" (see paragraph 50). This circumstance can occur where it has the object of "changing appreciably the structure of the market" (paragraphs 84-85). It derives from this legal

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[12] WHISH, BAILEY, *Competition Law*, Oxford University Press, Oxford, 2012, 82; MIDDLETON, *Blackstone's UK and EU Competition Documents (Blackstone's Statutes)*, Oxford University Press, Oxford, 2011, 502.

[13] CB v Commission (Case C-67/2013).

[14] Indeed, the case under examination is important also for the reiteration of the principle that the General Court must generally undertake a full judicial review and cannot therefore use the European Commission's margin of assessment for dispensing with an in-depth review of the law and facts.

[15] For instance a broad interpretation of restriction by object was adopted by the European Commission in the following cases: T-Mobile (Case C-8/08 T-Mobile Netherlands BV, EU:C:2009:343, paragraph 31); Allianz Hungària (Case C-32/11 Allianz Hungària, EU:2013:160, paragraph 48); Irish Beef (Case C-209/07 Beef Industry Development and Barry Brothers, EU:C:2008:643); GlaxoSmithKline (Case C-501/06 P GlaxoSmithKline Services Unlimited v Commission, EU:C:2009:610).

principle that the European Commission or national competition authorities must now show likely harmful effects on competition unless it can clearly and easily show that the restriction at issue, by its very nature, harms competition.

Specifically on the facts, the CJEU found that the General Court excluded the assessment of the degree of harm of the pricing measures at issue with reference to their content, and considered only the subjective intentions of certain members of the Group. In other words, the General Court confirmed its view to the broad interpretation of object restrictions. Indeed, the members of the Group, as indicated in internal documents seized by the European Commission, intended to adopt the pricing measures to impede competition by new entrant card issuers and to protect revenues, so limiting reductions in card fees paid by consumers. This was considered as a sufficient parameter to determine a restriction of competition by object.

For this reason, the CJEU found that the General Court did not apply correctly the legal principles in confirming the decision of the European Commission in relation to the concept of restriction of competition by object. Indeed, the General Court failed to assess whether the pricing measures of the Group had by their very nature a sufficient degree to harm competition and applied a lower threshold of whether the measures were "capable (…) of preventing, restricting or distorting competition" (paragraph 57). Furthermore, the General Court had also upheld that the concept of an infringement by object did not have to be interpreted in a restrictive fashion (paragraph 58). Indeed, as anticipated above it has been a common practice of the European Commission and national competition authorities to seek to expand the concept of restriction by object to adopt infringement decisions without having to assess the actual effects of an agreement on competition. For this reason, the CJEU argued a narrower interpretation of the concept. Thus, a mere assertion of negative effects on competition is not sufficient to establish a restriction of competition by object and a proper analysis must be undertaken as to why this is the case based on the wording, objective and context of the agreement or coordinated practice.

Therefore, the CJEU upheld that the General Court did not explain how the wording of the measures imposed by the Group led to a restriction of competition. It merely inferred that the rules impeded competition by limiting new entrants to access the French market for issuing payment cards (paragraph 68), and thus constituted a restriction of competition by object. For this reason, the General Court did not assess the changing of the structure of the market (paragraph 85). Therefore, the fees charged by the Group did not constitute a measure in itself capable of restricting competition by object, and should be challenged by assessing their actual effects on competition based on factual explanations.

Following these legal considerations, the CJEU upheld in line with Advocate General Wahl's opinion to set aside the General Court judgement and to refer

the case back to the same Court in order to carry out an analysis of the effects of the measures[16].

3.2. Remarks on article 101 (1) TFEU: a new legal interpretation of two-sided markets

The *Groupement des Cartes Bancaires* case is important not only for the new perspectives that have been introduced within the definition of restriction by object, but especially for the new trends that have been established in relation to novel or complex economic settings, namely network industries or multi sided-markets. Indeed, according to the CJEU those markets are not subject to a by object analysis because the latter is not adequate for determining whether such measures are caught by article 101 (1) TFEU.

In particular, from a theoretical point of view the CJEU has confirmed that where an agreement concerns a two-sided market such as payment systems or other related markets, its ability to harm competition must be assessed on all such markets. Indeed, payment systems comprise of the card issuing and merchant acquiring markets, with interactions between them leading to network effects[17]. Therefore, the CJEU concluded that when coordination concerns more than one market, a restriction of competition by object can be found only when that coordination is by its very nature harmful to competition on all markets to which it relates. In the case of two-sided markets, this must include an assessment of interactions between all the market sides (paragraphs 75 to 79).

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[16] Although the principal focus of this paper is on legal considerations in relation to two-sided markets in the application of article 101 (1) and (3) TFEU, it is important to highlight that generally considerable uncertainty still persists in assessing a restriction of competition by object or effect. Indeed, apart from general guidelines that have been offered by the CJEU in the *Groupement des Cartes Bancaires* case, it is not clear why measures that prevent market entry and expansion with a view to limiting price reductions, particularly where this is intended by the participants cannot change appreciably the structure of the market as much as hard-core price-fixing or output limiting cartels (namely, self-evident restrictions). Indeed, as the CJEU has pointed out the reason why those cartels are a self-evident restriction of competition by object is that "experience shows that such behaviour leads to falls in production and price increases, resulting in poor allocation of resources to the detriment, in particular, of consumers" (paragraph 51). However, behind these clear examples the question remains as to how to judge whether an agreement or practice has a "sufficient degree of harm to competition" to have the object of restricting competition. Relying on experience does not seem to be a sufficient parameter because it means that there is still a degree of judgment and, therefore, uncertainty and unclear requisites to assess a restriction by object or effect is still questionable. Furthermore, the *Groupement des Cartes Bancaires* case is unclear in relation to the depth or level of detail with which the context analysis should be undertaken. For instance, it has never been established a certain threshold for a reduction of outputs in order to be qualified automatically as a restriction by object. However, the real point is that it is welcomed that the CJEU has cautioned against an overly-expansive application of the concept of restriction by object.

[17] See paragraph 2 above for further arguments on two-sided markets and payments systems.

Indeed, on the facts of the *Groupement des Cartes Bancaires* case the General Court examined only the issuing market for card payments and did not take into account also the acquiring market. For this reason, the simple exclusion of an effect analysis due to the fact that a free-riding measure is by its very nature anti-competitive in terms of limiting new entrants to the market is no more justifiable. In particular, although such pricing measures would have lead some banks to change their contribution or prices, this change was precisely what the Group considered necessary to prevent the risk of implosion that was likely to occur due to the massive free-riding[18] by those who, without having invested in the creation and development of the payment system were admitted to use it.

Thus, the General Court should have recognised that a restriction by object was ruled out because the pricing measures adopted by the Group had in reality the effect of stimulating the acquisition activity through the imposition of higher fees to the issuing side. Additionally, the measures were proportionate and balanced because the members of the issuing side of the Group were free to choose between paying the higher fess or limiting their issuing activity. Therefore, the measures were imposed due to the possibility of enhancing positive network externalities, promoting diffusion of card payments and indirectly enhancing the utility of consumers.

Finally, the decision has also a practical significance for undertakings and regulators. Indeed, the narrow interpretation that has been imposed by the CJEU in assessing a restriction by object in practice means that the enforcer or challenger in novel situations or complex markets must now show anticompetitive effects for being able to claim that a particular agreement or coordination is caught by the prohibition of article 101 (1) TFEU.

4. The case of MasterCard I: the Background

On 19 December 2007, the European Commission found that MasterCard interchange fees on cross-border transactions within the European Economic Area

[18] The issuing side and the acquiring side involve contracts between the banks and the consumers/merchants. These contracts have different risk profiles and costs. Indeed, the contract between the issuing bank and the consumer is centred on the risk that the consumer is not able to repay the credit and the interest rate that the issuing bank will charge. On the other hand, the contract between the acquiring bank and the merchant is mainly centred on the promise of the bank to transfer the money to the affiliated merchant without a credit risk and concomitant interest rate. Therefore, financial intermediaries will try to focus their activities on the issuing side due to the attractive perspective of consumers buying on credit and thus having to pay interest rates. For this reason, the higher appeal of providing services on the issuing side can translate into a reduced incentive to invest in the acquiring side. This circumstance consequently can reduce network effects, because there will be less merchants who are willing to accept card payments. Therefore, there is a need for the card organisations to keep the banks on both sides active and prevent the free-riding problem.

(EEA) restrict competition between banks[19]. The decision of the European Commission was confirmed by the General Court by judgement uphold on 24 May 2012[20], subsequently upheld by the European Court of Justice decided on 11 September 2014[21].

By definition interchange fees are fees charged by the cardholder's bank (*i.e.* issuing bank) to the merchant's bank (*i.e.* acquiring bank) for each transaction carried out at the merchant's outlet. They can be agreed either on a bilateral basis, *i.e.* between issuing and acquiring banks, or on a multilateral basis by means of a decision which binds all banks parts to a payment card scheme; in this latter case, they are referred to as multilateral interchange fees (MIFs). A MIF can take the form of a percentage, a flat fee or a combined fee (percentage and flat fee)[22]. To this end, it is interesting to understand the rational of an interchange fee. The following passage is very interesting in order to better understand its *raison d'être*:

«(…) The rationale for interchange fee is complex, controversial, and deeply rooted in economic theory. The original economic framework, first developed by William Baxter, one time law professor at Stanford University (…) argued that a payment system should be viewed from an economic perspective that takes into account the demand and supply of payment services. The banks – issuers and acquirers – are the suppliers of payment services while the cardholders and the merchants are the consumer of payment services. The core argument in his theory is that the two banking entities jointly supply and the two consumers jointly consume payment transactional services. Joint supply means that one supplier cannot supply without the other and joint consumption means that one consumer cannot consume without the other. It follows that the demand for payment services by the consumers is joint and interdependent. (…) This is also referred to as the 'network' effect. [In the same fashion] the joint supply argument indicates that the costs of supplying payment services are also joint. The issuer's costs and the acquirer's costs, together, add up to the total cost of supplying payment services. (…) If there is an imbalance between the ratio in which costs are shared and the ratio of merchant and cardholder demand, it should be redressed and adjusted. (…) Baxter viewed the interchange fee as a primarily an adjustment fee to redress this imbalance»[23].

This passage is extremely interesting in discovering how the card payment systems are one of the most important instances of two-sided markets. Indeed, there is a joint supply of the banks (*i.e.* issuing and acquiring side) connected to

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[19] Commission Decision C (2007) 6474 final of 19 December 2007.

[20] MasterCard and Others v Commission (T-111/08, EU:T:2012:260).

[21] MasterCard and Others v Commission (Case C-382/2012).

[22] BERGER, MOLYNEUX, WILSON, *The Oxford Handbook of Banking*, Oxford University Press, Oxford, 2009, 416.

[23] SLAWSKY, ZAFAR, *Developing and Managing a Successful Payment Cards Business*, Gower Publishing, Guildford, 2005, 136.

a joint demand of customers (*i.e.* cardholders and merchants). In this light, indirect network effects are vital and the diffusion of a payment card does not only depend as explained in paragraph 2 of this paper on the cost for the issue of the card, but on the acceptance of the card by merchants. For this reason, the multilateral interchange fee is viewed as a means of balancing divergent interests in order to make those same interests convergent and, therefore, to promote indirect network externalities while preserving the utility of consumers.

The decision of the European Commission in the MasterCard case related to the so called ‘inter-EEA fall-back interchange fee’, a MIF applied to virtually all cross-border card payments made with MasterCard or Maestro cards as well as to domestic payments in several EEA Member States. It is called fall-back because it applies when no other interchange fee has been agreed bilaterally between the issuing and the acquiring bank: in practice, such fee applies to all cross-border payments made with MasterCard or Maestro cards between Member States of the EEA and to domestic credit card transactions within eight Member States of the EEA (namely, Belgium, Ireland, Czech Republic, Latvia, Luxembourg, Malta and Greece) and to domestic debit card payments within Greece and the Czech Republic.

The European Commission found that such fees had the effects of setting a floor under the costs charged to merchants and thus constituted a restriction of price competition, since merchants were unable to negotiate a price below it. Moreover, the European Commission deemed that no efficiency exemption pursuant to Article 81 (3) EC (now Article 101 (3) TFEU) applied since, even though interchange fees could in theory help optimizing the utility of a card network to all of its users, they render payment card acceptance artificially more expensive. In addition, as to the second condition of Article 81 (3) EC (now Article 101 (3) TFEU), the European Commission stated that it cannot safely be assumed that by pursuing its member banks’ aim of maximizing sales volumes, MasterCard’s MIF has created efficiencies that benefit all customers, including merchants. Finally, as to the third requirements of the recalled rule, MasterCard did not make evidences in relation to the fact that MIFs were indispensable to achieve a maximized system output or any claimed related efficiencies. On reverse, the European Commission considered that, if MasterCard operated without a MIF, merchants would pay lower prices for accepting cards and, as a consequence, their customers should also face lower costs for shopping.

In light of this, the European Commission ordered MasterCard to cease applying its current intra-EEA fall-back interchange fees for consumer credit and debit cards and to refrain from adopting measures having a similar effect. No fine was imposed on MasterCard, because it notified the MIF agreements to the European Commission between 1992 and 1997, and therefore benefited from immunity.

In 2009, to comply with the European Commission’s decision, MasterCard capped the intra-EEA cross-border interchange fees applied by its member banks

to 0.20% for debit cards and 0.30% for credit cards, but they did not reduce their other interchange fees.

4.1 The 2014 decision of the Court of Justice of the European Union

MasterCard challenged the European Commission's decision before the General Court, which upheld the finding of the European Commission. Subsequently, MasterCard brought an appeal before the CJEU, which was dismissed on the 11st of September 2014. In particular, MasterCard argued that the General Court had failed to take into account efficiencies that the MIF created to both merchants and cardholders. Indeed, the appellant claimed that the General Court focused its attention only on the benefits to merchants without considering that payment systems are an instance of related markets or better two-sided market that can create efficiencies for both sides, namely cardholders and merchants. Therefore, MasterCard pursued the recognition of a cross-market efficiency. In this regard, the CJEU held that the appellants failed to establish any such advantages in the merchant market and the restrictions that the MIF caused to the latter could not be offset by the advantages for cardholders in the related market[24].

In confirming the decision of the European Commission and the judgment of the General Court, the CJEU set forth the following significant principles:

- First of all, MasterCard could be classified as an association of undertakings: its decisions on MIF led to a coordination of conducts of the undertakings part of it and the collective interests of those latter coincided with those taken into account when the judgement was upheld;
- secondly, in relation to the question whether the MIF were objectively necessary for the MasterCard system, since their absence would supposedly have adverse consequences on the functioning of the system, the European Commission deemed that this did not mean that the MIF must be regarded as being objectively necessary: indeed, the General Court duly found that the system was still able to function without the application of these fees;
- thirdly, according to the European Commission and the General Court, some of the issues created by the elimination of the MIF could be hypothetically addressed by prohibiting *ex* post pricing (*i.e.* pricing effected after a purchase has been made by one of the issuing bank's cardholders from one of the acquiring bank's merchants and the transaction has been submitted for payment); the CJEU contested an error of law made by the General Court, since it should have ascertained whether that situation was likely to arise. However, the CJEU considered that such error did not affect the analysis on competitive effects of the MIF carried out by the

[24] See further paragraph 4.2 of this paper.

General Court, which was in any case justified by its relying on the European Commission's hypothesis.

4.2 Remarks on article 101 (3) TFEU: the balancing test vs. two-sided market

As it has been explained above article 101 (1) TFEU provided a dichotomy between restriction of competition by object and by effect. In particular, a possible anti-competitive agreement can be exempted from being caught by article 101 (1) if its negative effects are balanced against its pro-competitive effects under article 101 (3) TFEU. Indeed, under article 101 (3) TFEU an agreement that would have been prohibited under article 101 (1) TFEU can be considered as valid if four cumulative and exhaustive conditions are satisfied, namely:

- The agreement must improve the production and distribution of goods or contribute to promoting technical or economic progress;
- consumers must receive a fair share of the resulting benefits;
- the restrictions must be indispensable to the attainment of these objectives; and
- the agreement must not afford the parties the possibility of eliminating competition in respect of a substantial part of the products in question.

Furthermore, under the article 101 (3) TFEU Guidelines[25] (the "Guidelines") consumers must be compensated for any negative effects that the anti-competitive agreement creates. This means that consumers are allowed to a fair share of the benefits, so that the agreement has neutral effects and consumers are not directly or likely affected by it.

Consequently, in principle as a general rule the negative effects on consumers that are created in one product market cannot be compensated by the positive effects for consumers in another unrelated product market. Nonetheless, when product or geographic markets are related such as in the case of two-sided markets, article 101 (3) TFEU can be applied only if the «the group of consumers affected by the restriction and benefiting from the efficiency gains are substantially the same»[26]. It is the so-called consumer commonality. Indeed, this rule is made in order to avoid subjective evaluations that entail comparisons across different consumers that are related to different product or geographic markets.

In relation to the two-sided market nature of payments systems, the CJEU upheld an interesting conclusion in relation to the efficiency exemption under Article 81 (3) EC (now Article 101 (3) TFEU), namely the CJEU confirmed that it could not be applied in the present case. Indeed, in a two-sided system, it is necessary to take into account the effects of the contested measures on both sides of that system (*i.e.* the issuing and the acquiring side), especially when there is interaction between the two sides of the system in question. To that end,

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[25] Communication from the Commission – Guidelines on the application of Article 101 (3) TFEU (formerly Article 81 (3) TEC), OJ C 101 of 27.4.2004, paragraph 85.

[26] Id. paragraph 43.

it is necessary to assess, where appropriate, whether such advantages are of such a character as to compensate for the disadvantages which that measure entails for competition; moreover, the objective advantages should occur on both sides of the market. In this regard, the CJEU held that:

«(…) it is necessary to take into account the system of which that measure forms part, including, where appropriate all the objective advantages flowing from that measure not only on the market in respect of which the restriction has been established, but also on the market which includes the other group of consumers associated with that system. (…) where restrictive effects have been found on only one market of a two-sided system, the advantages flowing from the restrictive measure on a separate but connected market also associated with that system cannot, in themselves, be of such a character as to compensate for the disadvantages resulting from that measure in the absence of any proof of the existence of appreciable objective advantages attributable to that measure in the relevant market, in particular where the consumers on those markets are not substantially the same. For these reasons, the General Court correctly did not need to evaluate the possible advantages enjoyed by cardholders, in light of the absence of any proof of the existence of appreciable objective advantages enjoyed by the merchants»[27]

This confirms that the absence of consumer commonality that is required by the Guidelines is not, in itself, an obstacle to assess cross-market efficiencies. Nonetheless, in a two-sided system when there are negative effects limited to one market, the separate advantages created on the other market cannot compensate such effects absent the evidence of "appreciable objective advantages" on the market concern.

5. Conclusions

The first remark that can be drawn from the examination of the decisions above is that two-sided markets are not only defined by their platform tool. Indeed, the platform tool can be an essential element to assess anti-competitive behaviours in the case of mobile payments and mobile digital wallets. Nonetheless, the platform is only a tool to connect two different types of consumers and apart from specific cases cannot be found so relevant in defining the nature of two-sided markets. This is only an ancillary feature.

For this reason, this paper has argued that the main features to assess anti-competitive behaviours in relation to two-sided markets are: the functioning of their indirect network effects (this especially in terms of assessing the application of article 101 (3) TFEU), the price market structure (in particular in terms of assessing the application of article 101 (1) TFEU) and the level of diffusion of the product or service between different markets with different consumers.

[27] MasterCard and Others v Commission (Case C-382/2012), paragraphs 237 and 242.

Specifically on the facts of the decisions that have been taken into account in this paper, several principles have been established in relation to two-sided markets, and concerning the application of article 101 TFEU. Firstly, the *Groupement des Cartes Bancaires* case has shown that the analysis of restriction of competition by object is not sufficient in the case of two-sided markets. For this reason, the possible anti-competitive effects must be evidenced on the facts and follow a possible restriction of competition by effect. Furthermore, the assessment of a potential anti-competitive agreement cannot be limited to only one market side, but shall concern all market sides. This confirms the idea that one of the main distinguishing features of two-sided markets is their production of indirect network effects. To this end, the necessary assessment of anti-competitive effects to be carried out on all the market sides indirectly confirms the idea that in two-sided market industries the European Commission or national competition authorities shall provide a product and/or geographical market definition for each market of the industry (*i.e.* sometimes two markets such as in the card payment systems, whereas other times more than two markets such as in mobile payments platforms).

Furthermore, the MasterCard I case confirms the importance of the assessment of indirect network effects in the case of the application of efficiency exemption under article 101 (3) TFEU. Indeed, according to the CJEU's view in MasterCard I there are at least three fundamental principles in relation to two-sided markets to be observed in order to invoke article 101 (3) TFEU: firstly, the assessment of efficiencies in two-sided markets must take into account all the objective advantages flowing from both sides of the market; secondly, it is important to establish a minimum of efficiencies (*i.e.* appreciable objective advantages) in relation to the market side in which negative restrictive effects of competition occur for the benefit of the other related market side; once the minimum is set, the benefits the cross-border efficiencies can be evaluated notwithstanding the absence of any consumer commonality.

Therefore, these landmark decisions have been examined together in order to show from a practical point of view, as well as to confirm from a theoretical perspective, the important features of two-sided markets, and how those peculiar features can limit today the application of article 101 (1) TFEU concerning the restriction of competition by object and article 101 (3) TFEU in relation to the application of the efficiency exemption.

BOOK REVIEWS

A Journey through Ruth Wandhöfer's Book: "Transaction Banking and the Impact of Regulatory Change", UK: Palgrave-Macmillan, 2014

Ruth Wandhöfer was one of the lecturers at the first edition of the Jean Monnet Autumn School on "The Europeanisation of the Payment System. Learning from the past to address the challenges ahead", held at the University of Siena from 23 to 25 October 2014.

As academic coordinator of the Jean Monnet project I invited her to give a speech on the on-going developments of PSD and SEPA, as her first book dealt with European Payments Integration (Palgrave Macmillan, 2010), and her second volume, "Transaction Banking and the Impact of Regulatory Change" (Palgrave Macmillan, 2014), investigated the second Payment Service Directive draft within a wider international framework, analysing payment service regulation as one of several post-crisis regulatory measures. In the end, her speech was brilliant and held the audience's attention from beginning to end.

I am going to focus on "Transaction Banking and the Impact of Regulatory Change".

This book centres on the idea of "transaction banking". Actually, there is no regulatory definition to refer to. In the opinion of the Author, this is a wholesale form of banking, whose main clients are corporations, other banks, governments and financial institutions (for example, funds and broker dealers).

Transaction banking activities cover a combination of the following: i) payment and cash management, ii) trade finance, iii) custody, and iv) ancillary securities services. However, the most important feature of "transaction banking" seems to be the *network* dimension or, in other words, its *interconnectivity*: "Network banking, which is transaction banking, has a socially essential purpose and relies on (…) widespread interconnectivity" (page 58).

The book takes an international approach, making reference to relevant US, EU and UK regulatory initiatives where necessary, but the Author correctly refrains from a comprehensive analysis of post-crisis regulatory changes.

To assess the critical impact of some regulatory initiatives on transaction banking, the Author firstly overviews its banking and financial framework, pointing to the regulatory measures employed to improve financial stability (for example, MIFID rules or the Recovery and Resolution regime) and depositor protection, as well as the dialectical relationship between the increased level of harmonisation/standardisation on the one hand and the trend towards the "balkanisation of financial markets" on the other (page 9).

The Basel accord and payment services regulation, however, are examined in greater depth. Indeed, in chapter 4, Wandhöfer explains the basics of Basel I and what changes took place leading to Basel II and Basel III. In chapter 5, she critically focuses on the Payment Service Directive (or PSD) and the proposal for PSD2, drawing a comparison between the EU and US regulatory frameworks.

The real heart of the book, however, is to be found in chapters 6 and 7. Here, the Author critically examines the impact on the transaction banking model of Basel III regulation and argues her regulatory proposals.

On the premise that transaction banking does not seem to show major leverage or a higher level of speculation, the Author underlines how Basel III rules and regulations can reduce the "profitability of the bank's treasury" and this, in turn, can "reduce the amount of money that can be passed on to the transaction bank", thus influencing the level of infrastructure investments in terms of "safety of infrastructures", "regulatory compliance" and "innovative systems". In addition, further foreseeable consequences might be an increase in a bank's fees to its corporate, public sector and FI customers as well as reduced interest paid on their accounts.

The mechanism seems to work as follows: the bank's treasurer is entrusted with finding the best way to invest the available deposits in order to generate returns through the liquidity coming from transaction banking. However, the liquidity requirements set out by Basel III cut the bank's treasury resources in terms of "the type of products, the duration, the risk profile and the degree of liquidity" (page 218).

Coming to the regulatory proposals, Wandhöfer points to the importance of the global network and connectivity on which transaction banking is based, which, in turn, supports the functioning of the global economy.

Having established this premise, she proposes, among the other things,

- To make a change to the regulatory approach: "Prescriptive rules alone may not be able to prevent the next crisis. Instead, we need banks to be incentivised to be transparent and give them sufficient freedom to do their business" (page 258)
- To keep the ring-fencing risk under control. Indeed, when the lawmakers oblige foreign banks to ring fence capital and liquidity domestically, the range of services offered to customers ends up being reduced, with negative consequences especially for small and medium enterprises (page 259)
- To control the "too-big-to-fail" syndrome, the Author points to international cooperation according to a model established as part of the G20 process and greater recourse to principles-based regulation. Indeed, she writes, "(…) the more prescriptive and detailed the rules, the more complex it will be to supervise banks' compliance with these" (page 265).
- Finally, the Author suggested applying a bottom-up regulatory approach: "Having established harmonised accounting and reporting rules for large international banks all around the world and having improved the transparency of RWA measurements, my proposal would be to actually remove the Basel capital, liquidity and leverage ratio requirements and limitations altogether. Instead, large banks (…) should transparently disclose their capital and liquidity levels and their LRs according to the globally defined Basel III

formulas. (…) sufficient room for clarifying the different types of risks should be given as part of these disclosures” (page 266).

“Transaction Banking and the Impact of Regulatory Change” is far from being an academic book, and it does not claim to be. The bibliography and the book’s structure say a lot on the matter.

Rather, this volume - a useful informative text - is essentially a critical investigation of regulatory rulemaking from within the banking world. Its greatest merit is that it stimulates interest in side-based issues. To give just a few examples, one might question i) how transaction banking activities are referred to within the European legal framework and what degree of harmonisation has been achieved (apart from the provision of payment services), ii) how the institutional organisation of international economic governance has changed in the post-crisis framework or, iii) how the standardisation process among international economic players can raise antitrust issues and how the competent authorities deal with this.

Thanking Ruth Wandhöfer for this interesting read, I very much look forward to her next book.

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