Can an overseer overlook some basics? – The ECB on e-money and virtual currencies

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In October 2012 the European Central Bank published a remarkable study on "Virtual Currency Schemes"[1]. At that time, the Bitcoin exchange rate was still stable (about 12 USD per Bitcoin). But only a little later, in the beginning of 2013, the Bitcoin rally started reaching its peak rate of 237 USD in April. This rally led to an intensive worldwide discussion about the nature, challenges and threats of virtual currencies. The ECB report includes two case studies of the virtual currencies Bitcoin and Linden Dollar (of the Second Life virtual community). Based on its findings, it proceeds to discuss the relevance of such private unregulated (at least at the time being) currency schemes for central banks, published as an official view of the ECB.[2]

The ECB is not worried at the moment because the volume of virtual currencies is still low. Therefore it does not see them as a threat to financial stability. But the ECB notes that such virtual currencies could have a negative impact on the reputation of central banks.

Moreover, the ECB points out that the high degree of anonymity of virtual currencies poses a challenge to public authorities because virtual currencies could be used as means of payment for illegal activities and money laundering.

Virtual currencies are not regulated per definition used by the ECB. Therefore electronic money, which is regulated in the EU since the first E-Money-Directive of 2000, cannot be a virtual currency. Analyzing the impact of virtual currency schemes, a proper definition and categorization between virtual money and e-money, which is compliant with EU-regulation, is crucial. Let´s have a closer look to the genesis of these new currencies and their domestication by regulation before discussing the definitional misunderstandings of the ECB.

Genuine digital currencies like Bitcoin are decentralized digital bearer instruments stored in an electronic device (PC, chip card etc.). Such instruments are not a new phenomenon. The first wave of pioneers of this digital cash-equivalent, like Mondex and DigiCash, entered the monetary world in the mid-90-ies. Unfortunately, they did not survive. Similarly, the e-purses schemes that were meant to replace cash in the physical world did not gain much of the market and were discontinued in most European countries (except Germany where banks still ride an expensive, but almost dead horse called "GeldKarte").

In spite of the limited success of the early attempts to implement digital cash in the market, central banks and other oversight authorities in Europe introduced a wave of (premature) regulation of these digital currencies. In 2000 the first E-Money Directive (2000/46/EC) was passed – long before any relevance of these e-money products could be detected.

Indeed, with the closure of most schemes, there was hardly anything that fell under the new regulation. But rather than having an empty regulatory box regulators started to widen the definition of e-money to include all kinds of other new payment instruments. Later on, this regulatory practice found its way into the definition of e-money in the second E-Money Directive in 2009 (2009/110/EC).

As a consequence, today most of the e-money schemes which fall under the scope of the e-money-regulation have nothing to do with genuine e-money in the sense of digital cash (digital bearer certificates).

Most of today's e-money consists of balances held in special "prepaid" accounts, centrally administered by the issuing institutions. These accounts are like limited purpose accounts comparable to a current account at a bank that has a restricted functionality. PayPal is the well-known market leader of this kind of e-money.

So, in the EU, we have had regulations in place for genuine e-money and other prepaid products for more than 10 years. As far as we can see, most "virtual currencies" would simply be treated as "e-money" if they were issued in the EU. However, notwithstanding the existing regulations, the ECB Report makes a comparison between "E-Money" (regulated) and "Virtual Currencies" (not regulated). It identifies two types of virtual currency schemes,

- closed schemes and
- schemes with a monetary inflow via currency exchanges (traditional exchange: currency versus virtual currency).

In contrast to e-money, the unit of account of virtual currencies is an invented unit (like Bitcoins). Moreover, as stated by the ECB-report, there is no guaranteed redeemability of virtual currency funds into traditional currency.

The analysis of the ECB is striking for a number of reasons:

First, it is remarkable to see that the ECB is using an outdated definition of e-money (of the invalid EMD I) which not complying with the current e-money definition of the EMD II and the regulation within the EU.

Second, no matter whether the EMD I (not relevant since 2009) is used or EMD II, the core characteristic of e-money has remained the same: issuance on receipt of funds (= prepaid). This implies that every virtual currency which is issued (not traded!) in exchange for traditional money is legally defined as e-money (if the other requirements are fulfilled too).

Thus, the equation "virtual currency = unregulated" applies only in special cases like Bitcoin. Otherwise, those currencies defined by the ECB as "virtual currencies", which are issued via an inflow of traditional currency, are subject to e-money regulation in the EU! Linden Dollars or Liberty Reserve Dollars (both "prepaid") would be subject to e-money-regulation if issued within the EU-jurisdiction. All of these schemes would have to be redeemable at par. This is a regulatory requirement (Article 11 of EMD II) and cannot be part of a definition or a criterion for categorization, as in the ECB report. (By the way, when the EMD I was drafted in 1999, the ECB itself insisted on this requirement).

Third, the report states that e-money is (in contrast to virtual currencies) always issued in units of account of existing legal tender currencies. This is also not correct. Regulated e-money can be issued in fantasy units but the exchange rate vis-à-vis the legal tender currencies must be fixed ("issuers issue electronic money at par value on the receipt of funds", "issuers redeem, at any moment and at par value"). The denomination is not essential! The ECB is missing the point by stating: "lastly, the fact that the currency is denominated differently (i.e. not euro, US dollar, etc.) means that complete control of the virtual currency is given to its issuer, who governs the scheme and manages the supply of money at will."[3]

Fourth, another criterion of categorization used by the ECB is the acceptance of the currency: only virtual or also real goods and services. A good or service is virtual, if it is offered within a virtual community and cannot be traded outside the community (ECB-definition). From a monetary and regulatory point of view the kind of goods and services which can be bought with a particular currency has no relevance, at all. Relevant could be the level of acceptance at third-parties (besides the issuer) whether in a virtual or real world.

So, as rule of thumb: if a virtual currency is prepaid, it is e-money with the regulatory requirement of redeemability at par value. Only non-prepaid currencies in closed systems (like Bitcoin or some in-game currencies) could be considered as non-regulated virtual currencies in the EU.

Central banks are monopolist providers of cash. So, they may be forgiven when they do not spend an awful lot of time observing and analyzing competitors. But central banks are also regulators and as such they should – at least after 10 years of experience – understand what they are regulating and what the regulations are.

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[1] ECB, Virtual Currency Schemes, October 2012

http://www.ecb.int/pub/pdf/other/virtualcurrencyschemes201210en.pdf

[2] It should be noted that the report is not published as a Working Paper or Occasional Paper under the names of specific authors. It is published as a report authored by the ECB/Eurosystem. As such it does it contain the usual disclaimer that can be typically found in reports of individual authors.

[3] ECB (2012), p. 5.

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