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CENTER FOR ADVANCED STUDIES

ON THE REGULATION OF THE NATIONAL FINANCIAL SYSTEM

NEASF

9th MEETING OF THE CENTER FOR ADVANCED STUDIES ON THE REGULATION OF THE NATIONAL FINANCIAL SYSTEM

FGV DIREITO RIO

OPENING REMARKS

On December 4, 2020, the ninth meeting of the Center for Advanced Studies on Regulation of the National Financial System (NEASF) was held by the Center for Research in Law and Economics (CPDE), part of Fundação Getulio Vargas' Rio de Janeiro Law School.

NEASF's main objective is to contribute to better regulation of the national financial system through research and analysis that make it possible to diagnose problems and identify opportunities to improve Brazil's financial sector. NEASF is a multi-stakeholder organization involving representatives of academia, the market and government. Through debates and roundtable discussions, its members discuss topics related to regulation of the national financial system, contributing to broader understanding of the sector, trends, risks, any regulatory gaps and their implications.

The chosen subject of the ninth meeting was "Payment Arrangements: Regulatory Challenges and Possibilities."

SESSION 1

REGULATION OF INTERCHANGE FEES FROM THE PERSPECTIVE OF PAYMENT INSTITUTIONS

The first session dealt with common regulatory aspects in different payment markets, especially in Latin America. Adjustment and control measures imposed through regulation were addressed, as well as potential challenges and trends in the payments market. This discussion was based on the premise that competitive payment markets featuring a high penetration rate and the use of electronic payment instruments tend to be more regulated.

In order to explain common types of regulations in different markets across the world, it was mentioned that payments markets have tended to develop in a vertical manner, specifically the credit card market. Due to the two-sided structure of this market, the availability of payment instruments (card issuance) needs a payment scheme, so the credit card market emerged in a vertical manner, as payment issuers realized payment schemes' limited presence and so started to accredit merchants.

Thus, across Latin America, a common regulatory move has been the unbundling of the card issuing market and the accreditation of commercial establishments. There have been major differences between countries, generally driven by antitrust authorities.

In Brazil, in order to encourage the entry of new players, the Brazilian Antitrust Regulatory Agency (CADE) banned exclusivity between payment institutions and acquirers. This measure, taken in 2010, provides an example of unbundling of the payments market driven by an antitrust body.

Various examples of interventions to de-verticalize payments market participants in Latin America were mentioned. Recently, Colombia's antitrust agency issued a report highlighting the need for segregation and setting out the roles of participants in the payment ecosystem. In 2016, the Argentinean government's Competition Commission determined the end of exclusivity for accreditation activities, as well as divestment measures for the market's main acquirer, controlled by financial institutions, which had a market share of approximately 90%.

It was said that the unbundling movement has driven regulation in many countries, and this is explained by the way payment markets were formed. During this unbundling process, regulations have started to address the roles of each participant in the payment market and to define which services are provided in the payment network and the levels of regulation that would be necessary. Card issuance activity was carried out by traditionally regulated financial institutions, so the challenge was to recognize the roles and responsibilities of deregulated institutions.

There are similar methods of regulating and supervising these new institutions in different markets. For example, accreditation activity is directly regulated by the central bank or financial commissions in most parts of the world, requiring minimal regulatory capital and licenses issued by regulatory bodies. In the few markets where

a license is not required, there is at least supervision by agencies in charge of money laundering protection programs.

Payment service providers or sub-acquirers / payment facilitators may be deregulated, indirectly regulated or regulated from the moment they acquire a significant role in the dynamics of the payment market. The level of regulation varies by country. As for electronic currency issuers, it was mentioned that the regulatory challenge is to regulate new payment instruments provided by institutions that are not necessarily financial.

It was commented that there are cases of regulations that distinguish between switching[1] and payment scheme[2] activities. In Chile, activities that do not interfere with the flow of transactions are deregulated. In Colombia, only switching is regulated. In Europe, both activities are regulated by different regulatory entities and if a specific company is involved in both activities, it needs to have a Chinese wall to completely separate its activities, teams and responsibilities.

Another regulatory point mentioned as common to different countries is recognition of coexistence of payment schemes that have two, three or four parties. The regulatory challenge here is to harmonize interactions between these models in the same regulatory environment, defining standards for interoperability, settlement and risk management, for both systemic risks in financial flows and know-your-customer policies.

Three common issues in terms of payment scheme regulations were discussed, involving measures to maintain, apply or enforce regulations in different countries: (i) price control and regulation; (ii) interoperability; and (iii) nationalist measures.

With regard to price control and regulation, it was mentioned that these measures are adopted not to promote competition (opening the market to new participants), but because of the legacy of the way the payment market was formed, so that incisive interventions may be necessary to change the context in which established economic agents dominate the market. The most common price control measure is the regulation of interchange fees.

Brazil was mentioned as an example, due to the regulation that stipulated a weighted-average cap on interchange fees charged in debit card transactions (Brazilian Central Bank Circular 3,887 of 2018). The payment markets of Uruguay and Costa Rica were cited as demonstrations that price regulation can affect the discount rates of commercial establishments charged for services provided by acquirers (the merchant discount rate).

In Chile, the market developed based on a single acquiring institution with a 90% market share, and currently, the prices charged to merchants are defined through self-regulation. The legacy of the Chilean payments market, developed on the basis of a monopoly agent, makes it hard for regulation to tackle competitive challenges. The extreme intervention model, in which the regulator sets all charges in a payment scheme, is non-existent in Latin America. China was mentioned as a market in which charges are defined by the regulator.

With regard to interoperability, it was

[1] Understood as the activity of intermediating and connecting systems on both sides of the payment market.
[2] Understood as the set of rules governing relations between payment scheme participants.

observed that the opening or closing of payment schemes can be seen in different ways, depending on the characteristics of each market. It was commented that there may be regulations that require interoperability and regulations that provide for interoperability within the same payment scheme or between different ones. There are also countries where interoperability arises from market forces and the institutions themselves decide to interlink their payment systems.

The meeting's[3] participants also discussed nationalist measures, represented in Latin America by the case of the payments market in Venezuela, in which there is an obligation to process transactions and locate payments in order not to depend on foreign players.

Potential challenges and trends in payments markets were also discussed. The first challenge mentioned was the arrival of technology in payment markets, which has allowed certain retail segments to work with new institutions. At the same time that technology has enabled new business models, it has also brought the challenge of considering whether regulation is capable of protecting the market from systemic risks.

As a potential trend, it was said that regulators play a central role in promoting competition between different forms of payment. Brazil's new instant payment scheme, PIX, Mexico's instant payment scheme, CoDi, and Transfer 3.0, which is being implemented in Argentina, were mentioned. In Europe, the Pan-European Payments System Initiative (Pepsi), since renamed the European Payments Initiative (EPI), an initiative created to stimulate competition, was cited.

The last potential challenges discussed were the arrival of new participants in the payments market, in particular tech giants, and the issuing of digital currencies by central banks (central bank digital currencies). The arrival of new participants represents a challenge, since they are not necessarily regulated entities, and the provision of financial and payment services by big tech is hard to classify, which imposes some sensitive competition issues.

As for the issuing of digital currencies by central banks, it was argued that this innovation could change the entire traditional structure of the payments market. It was mentioned that the Brazilian Central Bank has formed a working group to discuss this subject, the Uruguayan regulator has issued currency in controlled environments, and the discussion is slightly more advanced in Europe, although it is still in its early days.

[3] The know-your-customer principle can be understood as a set of actions and strategies to be adopted by institutions when collecting data and information about their customers, in order to safeguard their interests and help prevent illegal practices in the financial system.

SESSION 2

SEVEN YEARS SINCE LAW 12,865 OF 2013 WAS PASSED: LEGAL FRAMEWORK'S IMPACTS ON PAYMENT INSTITUTIONS

The title of the second session was "Seven Years Since Law 12,865 of 2013 Was Passed: Legal Framework's Impacts on Payment Institutions." To begin with, the participants discussed the Brazilian Central Bank's mission, which is to ensure the stability of the currency's purchasing power and guarantee the financial system's solidity and efficiency. An overview of how competition has been a part of the Central Bank's mission over the years was presented.

It was mentioned that, for two decades, the Brazilian Central Bank endeavored to guarantee the stability of the currency's purchasing power, which was achieved in 1994 and reinforced in 1999. In the 20 years since then, it has established inflation targets. One effect of achieving stability in the currency's purchasing power was the weakening of the financial system, as financial institutions in the private and public sectors stopped collecting inflation-related revenues.[4]

Subsequently, the phase aimed at building a solid national financial system began. Over the course of the 2000s, the Brazilian Central Bank implemented the Basel Accords, among other measures.[5] It was mentioned that the financial institutions that were strengthened during this process are solid in terms of capital, leadership competence and technology, similar to the institutions existing in the United States and Europe since the 2008 crisis. However, one of the effects of achieving this objective was the creation of a concentrated financial system with lower than expected levels of competition.

At the present moment, the Brazilian Central Bank is working on its goal regarding the efficiency of the national financial system. The session's participants said that the bank should also strive to maintain the stability of the currency's purchasing power and the solidity achieved by it, which involved regulatory caution during the economic crisis that Brazil faced from 2013 to 2015 and also during the COVID-19 pandemic in 2020.

The session also addressed technology as a vector for efficiency, competition and innovation in the financial system. It was pointed out that technology has re-

[4] Revenue generated from the loss of the real value of deposits made by customers of financial institutions. One possible way for financial institutions to generate inflation-related revenue is to pay depositors interest that does not compensate for inflation while charging lenders more than inflation.

[5] Recommendations formulated by the Basel Committee on Banking Supervision, a forum composed of 45 monetary authorities, with the objective of issuing recommendations on cooperation between central banks and other institutions to mitigate the risks inherent in financial activity, reinforce banking regulation and supervision, and promote best practices in pursuit of monetary and financial stability. The recommendations were made in 1988 (Basel I), 2004 (Basel II) and 2010 (Basel III). For more information, see https://www.bcb.gov.br/estabilidadefinanceira/recomendacoesbasileia. Accessed on December 14, 2020.

duced the scale needed for an institution to be considered competitive. As a result, institutions require fewer customers to be profitable in the market. It was said at the meeting that the competition of the future will result from institutions with different business models, which will be capable of reducing the market power of institutions with larger market shares.

It was also observed that physical bank branches are important, despite the emergence of digital institutions in the country. The latter have played a key role in reducing prices and margins while increasing financial inclusion, but a network of physical branches is still a competitive advantage, albeit one that is declining over time. The example of cooperatives was given. They are based on a model of physical branches and there is room for them in the Brazilian financial system.

With regard to technology as a vector of competition, it was said that a technological break with traditional business models has occurred, especially in two markets: (i) the payments market; and (ii) the market for distributing investment products.

As for the payments market, it was mentioned that it can be considered a gateway, since the institutions that have emerged in the payments market in recent years largely started off in traditional markets such as credit. Regarding the investment product distribution market, there are some success stories that other players have sought to replicate in the sector.

It was observed that, in this context, the role of the Brazilian Central Bank is to promote the capacity for innovation and ensure that the benefits brought by new business models are passed on, even partially, to consumers. As well as maintaining the soundness of the financial system, it was said that data protection must be guaranteed to citizens and businesses, especially following the passing of the General Data Protection Law (Law 13,709 of 2018), the structuring of the National Data Protection Authority (ANPD) and the entry of tech giants into the payments market.

Technological innovation movements have posed new regulatory challenges. Regulation of the Brazilian financial system, like that of other countries, is in accordance with activities performed (by institutions such as commercial banks, retail banks and brokers). Currently, there is a risk that some institutions that apply for an operating license will not have their activities described in any specific license. Regulators also have the challenge of understanding how new business models work.

Another regulatory challenge, it was said, is that payment activities may be confused with other financial services provided by the same corporate group, making it difficult to know where each operation begins and ends, as well as who is responsible for carrying it out. Having extensive knowledge of the service chain makes it possible to understand the risks of each activity and possibly define the responsibilities of each agent in the payment network.

Research by the European Central Bank indicating that increased innovation tends to reduce financial stability was mentioned. However, it was said that Brazil is at a stage where innovation is possible without jeopardizing the stability of the national financial system. In addition, two factors were mentioned as present in international and national reports that were intended to assess increased competition in the financial

system: scarcity of information and scarcity of collateral (credit operation guarantees).

As for scarcity of information, the implementation of the new "cadastro positivo" list of good payers in Brazil was cited as a significant factor for increasing competition, but limited, since only financial information is shared, leaving out everyday information such as information available on social networks. Nevertheless, it was said that the frontier of information sharing has been expanded in this way, and open banking can provide faster and more accurate information.

Regarding scarcity of collateral, two projects were mentioned: registration of card receivables and transformation of trade receivables. Registration of card receivables is one of the main guarantees in credit operations that small companies have. With regard to electronic trade receivables, the idea is to transform them into credible collateral, since they currently only make it possible to know a merchant's cash flow. Electronic trade receivables also allow information to circulate, so that each person recognizes creditors and debtors, avoiding the issuing of trade receivables without linked commercial transactions.

Brazil lacked a regulator for the retail payments area until 2013, when Law 12,865 was passed, which attributed regulatory competence in this field to the Central Bank. Thus, the evolution of the card industry was largely due to regulation. When the Central Bank started to regulate the market, it faced challenges such as vertical integration, discriminatory access, network neutrality, risk management and price-related efficiency.

The session's participants discussed the duopoly that existed in the Brazilian payments market until 2010. This generated high costs and limited accreditation of commercial establishments, since one of the costs involved in accepting cards is the fee that remunerates acquirers (the merchant discount rate), which was defined by duopolistic agents. It was mentioned that the number of acquirers has doubled in the last five years, partly motivated by the end of the duopoly, a movement accompanied by a reduction in fees charged in the payments system, increased competition in the card receivables market, an increase in the number of accredited parties, growth in card transactions and a decrease in the time taken to transfer funds to merchants.

Another future challenge discussed in the session was the instant payment scheme developed by the Brazilian Central Bank, called PIX. It was noted that more than 40 countries have instant payment arrangements and the Chinese model was cited as one of the most developed. Advantages associated with PIX include the time to receive funds, immediate settlement and low associated cost – factors that benefit small establishments. Likewise, the convenience of paying via PIX was highlighted, since consumers are looking for payment instruments that enable connections at the time of purchase and payment.

The following advantages associated with PIX were also mentioned: reduction in cash transactions, which increased during the pandemic and pose social risks such as theft; the fact that PIX is open, so all member institutions can offer the same services, creating the possibility of smaller institutions targeting niche markets; and the ability to connect between different systems, facilitating payment reconciliation and control.

Concern was expressed about fraud in the payments market and particularly the cost of combating fraud as a potential barrier to the entry of new institutions into the market. Therefore, in view of the organization and continuous development of the structures that support fraud in the Brazilian payments market, as well as the high cost of fighting fraud, it was said that some technologies may limit competition over time, which is another challenge for regulators and payment institutions.

It was observed that one-third of remote transactions in Brazil are rejected because issuers do not have all the necessary authentication information and fail to assume the risk of operations. In this sense, the convenience of consumers whose transactions are not authorized is reduced.

In terms of PIX's security, it was said that the Brazilian Central Bank and financial institutions have a permanent working group on this subject and there is constant dialogue between the regulator and public security organizations. The limits imposed on transactions carried out via PIX during the day and at night and the possibility of identifying the bank account receiving the money in the event of theft or fraud were highlighted. The possibility of financial institutions being able to geolocate transactions in future and communicate with other institutions in the event of suspected fraud was also highlighted.

The session's participants reflected on the imbalance between risk and return in credit card schemes caused by interest-free installments, in which cross-subsidies can cause higher interest rates for end consumers. It was said that interest-free installment payments are a product that pleases both merchants and consumers who have difficulty associating interest-free installments with possible cross-subsidies.[6]

It was mentioned that the main source of remuneration for issuing financial institutions is interest charged on those who delay payment of invoices, as the annual and interchange fees no longer cover the risk associated with operations. Although interest-free installments are economically inefficient, it was observed that the regulator has difficulties in inhibiting a product that has no irregularities. Therefore, short-term solutions that are politically supported must be sought beyond the sphere of the regulated and regulator.

Still on the subject of interest-free installments, it was said that PIX does not have an immediate substitute for this form of payment. One of the features to be implemented in PIX is the possibility of payment in installments. In this case, the financial institution will still decide on the interest charged to customers, as it is responsible for guaranteeing the payment. Financial education was mentioned as a way to reduce the use of interest-free installment payments, but this change is not expected in the short term.

It was asked how innovations in the payments market may affect credit risk and systemic risk itself. It was said that PIX is a technological structure and a set of rules with inherent risks, but prudential regulation

[6] The potential cross-subsidies that exist in interest-free installments are as follows: (i) the card issuing financial institution charges higher interest to consumers who choose interest-based installments to offset the loss resulting from interest-free installments; and (ii) the merchant raises the price of the product or service provided, in order to embed the interest, meaning that consumers who pay in cash end up subsidizing purchases made by people who opt for interest-free installments.

is there to manage these risks.

The role of payment institutions in the model implemented by PIX was discussed, and it was mentioned that payment institutions provide payment technology services so that consumers can decide which payment method is most convenient for each transaction. In this sense, PIX's biggest impact will be on competition, forcing business models to adopt beneficial strategies for consumers.

Finally, the Brazilian Central Bank's Public Consultation 78 was discussed, which will discuss rules to harmonize the prudential treatment applicable to payment services. It was asked whether such harmonization could clash with the development of a competitive market, since minimum standards of regulatory capital and segregation of resources could be barriers to market entry. Payment institutions have responsibilities to merchant acquirers and, given the volume of transactions, the risks associated with the services provided and the multiple activities performed by payment institutions, prudential regulation has an important role to play.

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