

“Virtual Currencies: Are They for Real?”

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Virtual currencies: magic- or madness? Plaything for the rich- or payment vehicle for the unbanked? Passing fad- or here to stay? We often hear these questions today. What is certain is that virtual currencies (VCs) are for “real”: they are here to stay for the foreseeable future. But what is also certain is that they are fraught with uncertainty and anxiety.

A few years ago, VCs (and Bitcoin specifically) were practically unknown. Now they feature regularly in the media and make news headlines. Pretty much everyone is now familiar with VCs. Interest in VCs is growing, and so is their popularity.

The attraction of Bitcoin

One reason for the rising public interest may be the fascination with the **mysterious origin** of Bitcoin. Its presumed creator is an individual or a group of people. Recently a *Newsweek* journalist claimed to have revealed the true identity of the Bitcoin founder, supposedly a 64-year-old Japanese-American named *Satoshi Nakamoto*. However, Mr. Nakamoto has denied his involvement. The mystery remains.

Another factor in Bitcoin’s attraction is the underlying **technology** – Bitcoin technology is new, dynamic and evolving. In 2009, the first units Bitcoin appeared. Bitcoins exist as computer code based on cryptography and are stored on electronic wallets. Bitcoin does not require a central clearing house or financial institution clearing transactions. Users must have an internet connection and Bitcoin software to make payments to another public account/address. The user can send payments within a decentralised, peer-to-peer network, can purchase and sell Bitcoins through online exchanges and trade Bitcoins for traditional currencies. A total of about 12 million Bitcoins are currently in circulation, with another 3,600 new Bitcoins entering the market each day. The system is designed to produce no more than 21 million Bitcoins.

A further appeal of Bitcoin is linked to the perception that it enables the investor to **create enormous wealth**. That might have been true in Bitcoin’s earlier days: when the currency first emerged in 2009, it was worth a fraction of a USD cent. In 2013, Bitcoin started the year at just USD13. And then it reached a peak value of USD1,200 in early December 2013. Thus enormous financial gains were possible at the right time. But from that peak the price of a Bitcoin plummeted to less than USD100. Mismanagement, cyber-attacks and theft of a substantial amount of Bitcoins forced a market-leading exchange (*Mt. Gox*) to file for bankruptcy and close its doors. In addition, several jurisdictions started to subject Bitcoin transactions to tax. Currently Bitcoin trades around USD 470 and exhibits a considerable amount of price volatility.

While Bitcoin has generated interest as an investment, many perceive its value primarily as an **alternative payments method**: Bitcoin transactions are faster and cheaper than traditional payment transactions routed via banks. Bitcoin is thus touted as helping financial inclusion of the unbanked: populations that do not have bank accounts but can access the internet could theoretically make or receive Bitcoin payments. However, these benefits are more relevant in emerging markets and less relevant in the European Union where existing and pending EU regulations and directives are already explicitly aiming at increasing transaction speed and reducing cost (SEPA has played an important part in this area).

Virtual currencies carry real risk

But the benefits seem to be outweighed by **risks**. In fact, in its July 2014 “Opinion on virtual currencies”, the *European Banking Authority* (EBA) identified 70 VC risks across several categories, including risks to users; risks to non-user market participants; risks to financial integrity, such as money laundering and other financial crime; risks to existing payment systems in conventional currencies, and risks to regulatory authorities.

So what are the pros and cons of VCs (including Bitcoin) for consumers, merchants, and banks? Each category has quite different perspectives.

The consumer viewpoint

Currently only a small percentage of consumers are paying for purchases in VCs: according to EBA estimates, the number of global VC transactions has never exceeded 100,000 per day across the globe, compared to approximately 295 million conventional payment and terminal transactions per day in Europe alone (i.e. credit transfers, direct debits, e-money transfers, cheques, etc.). Some consumers are simply not aware of VCs yet. Some find that merchants do not yet accept the digital currency – although this is changing and the number of merchants accepting VCs is on the rise. Some consumers see no compelling reason to switch from credit cards to VCs. And in terms of using VCs as an investment opportunity, consumers in countries with stable currencies prefer investing into their own legal currency rather than into a digital currency with high volatility. Could VCs therefore be more attractive to countries where there is fiscal mismanagement, hyperinflation, and the likelihood of a currency collapse? Possibly. We are already seeing the greatest interest in VCs coming from emerging economies in Africa, Asia and Latin America.

National regulators in various countries have pointed out the risks of VCs: consumers may lose their money on an exchange, their VC units may be stolen from their digital wallets, consumers are not protected when using VCs as a means of payment, the value of VCs has been very volatile. Individuals holding VCs may be subject to unforeseen tax liabilities. And last but not least, transactions in VCs may be misused for criminal activities.

So, from a consumer perspective Bitcoin has a long way to go.

The merchant prospects

In today's environment most merchants have no choice but to offer credit cards. But this implies cost (transaction fees imposed by credit card companies and banks). And credit card fraud is on the rise. In contrast to credit card payments, Bitcoin purchases are final, so there are no chargebacks and no returns, saving merchants cost. No wonder then that some merchants are interested in alternatives to traditional payment methods. The number of on-line retailers, hotels, travel agencies and coffee shops accepting VCs has indeed risen dramatically and is expected to do rise further: *Coindesk* estimates that 100,000 merchants will accept Bitcoin by year-end. In Europe, there seem to be approximately 11,000 merchants currently accepting Bitcoin. *PayPal* has just announced that it will soon enable merchants on its payments processing network to accept Bitcoin. Even universities have started to accept Bitcoin as payment for tuition and other fees. Some are offering courses in their teaching programmes to enable students to understand VCs and the emerging area of digital law.

If consumers are willing to overcome the risks of VC, merchants may find it useful to offer VCs as an addition to traditional payment methods.

The banks' dilemma

The emergence of VCs has put banks into a very difficult position. In the current payments environment, banks must deal with increasing investments into payment processing as payment systems and platforms must continually be updated and maintained. Regulatory requirements add to the cost pressure. As a result, banks' transaction fees cannot match VC transaction fees. And banks cannot compete with VCs: several national jurisdictions have decided to ban financial institutions from interacting with VCs or even maintain current account relationship with businesses active in the field of VCs.

So it seems that in multiple countries banks may be on the losing end in this new area of VCs.

The regulators' concerns

National regulators everywhere have started to review VCs. Some have banned VCs, others restrict certain activities, while a third part are still monitoring and reviewing their position. Several central banks have issued warnings to their country's citizens about the risks of investing in VCs. And pan-European authorities such as the EBA and ECB have launched studies and reviews.

What is certain is that VCs and Bitcoin are "for real" and are here to stay. But much will depend on how regulators respond. What laws might foster or restrict the use of VCs? These topics will be explored in a second and third article in this series.