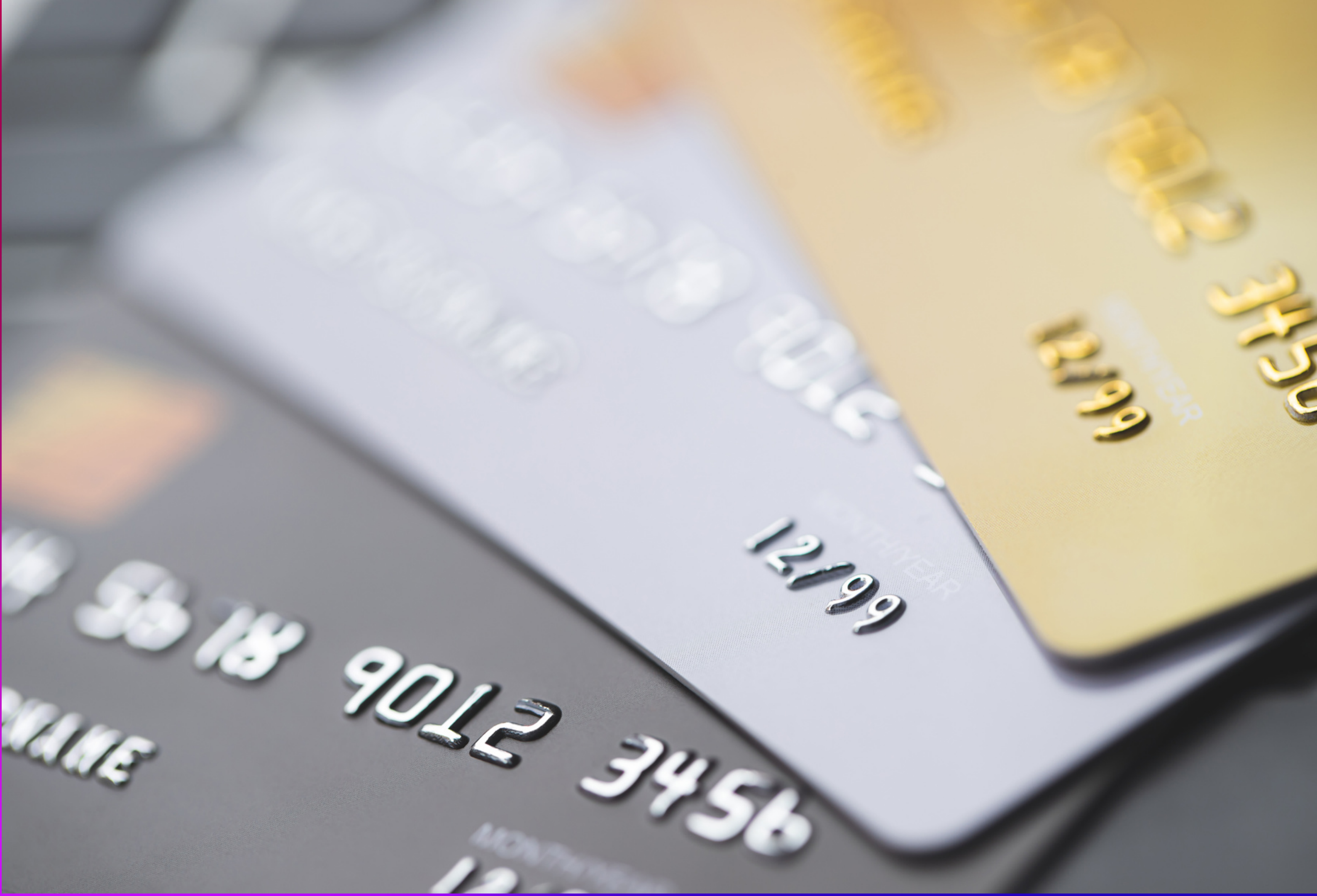

Can domestic payment systems shield economies against high third-party reliance risks?

Written by Kledjona Mollaj, a consultant in our Cards and Payments segment.

SHAPING THE FUTURE

Disclaimer: Since February 2022, there has understandably been very extensive coverage of the Russian invasion of Ukraine. The following article attempts to explore the link between payment systems and geopolitical decisions and does not seek to comment on other aspects of the conflict.

Can a domestic payment system protect a local economy against international financial sanctions? Russia has shown it can, at least partially.

Russia demonstrated it can, at least partially. The Russian government has been actively taking measures since 2015 to ensure its payment system can continue running even in the face of severe economic penalties. Developing domestic payment alternatives might become more common among nations concerned about potential sanctions.

The recent example set by Russia highlights the significance of payment systems on geopolitical terms. Whether Russia will become the proof of concept some countries need to develop national payment alternatives that can shield their economies remains to be seen. But what is it that Russia did and how well-prepared was its payment system when sanctions came into force?

Domestic card schemes (DCS) have been used to compete with international networks for many years

A card network (or as commonly referred to, a card scheme) is a payment system that consists of two main elements:

1) The **card scheme** element that sets the network rules, the pricing, and manages the brand and scheme members

2) The **card processing** element that covers the authorisation, clearing and settlement of card transactions

International card schemes (ICS) provide the infrastructure to issuing banks (issuers) for card issuance and acquiring banks (acquirers) to acquire card transactions either domestically, or internationally. The largest ICS are Visa and Mastercard.

A DCS, on the other hand, is an intra-country payment network that enables cardholders to transact only within that local jurisdiction. The efficient cost structure and capacity to develop payment products specific to local market requirements make DCS very competitive against international card networks on a domestic basis. 26 EMEA countries have already developed their own DCS for varying strategic and economic reasons (e.g. Mir in Russia, Girocard in Germany and Multibanco in Portugal).

Russia set up its own DCS in 2015 responding to economic sanctions imposed by the international community one year earlier

In 2014, the Bank of Russia established the National Payment Cards System, known as NSPK. Both Mir, a DCS, and the Faster Payments System (FPS), an alternative to SWIFT, were later established as sub-divisions of NSPK. The aim was to decrease the sanction risks experienced when Visa and Mastercard had to withdraw services to two Russian banks as a result of sanctions imposed after Russia's annexation of Crimea in 2014.

Mir was set up with national autonomy in mind.[1] When developing a DCS, local stakeholders can choose to partner with an international network to lease its tech infrastructure (e.g. TROY - Turkey's DCS) has a partnership with Discover, the US-based ICS) or develop proprietary infrastructure. Mir selected the latter path.

"Mir was set up with national autonomy in mind."

Many DCS also partner with international ones to ensure mutual acceptance via co-badging arrangements and extensive cross-market card usage. Mir, tellingly, partnered with UnionPay International, the ICS originating from China, to

[1] *Mir breaks Visa-Mastercard duopoly in Russia (finextra.com)*

ensure the co-branded cards would be accepted wherever UnionPay International was accepted, thus ensuring no dependence on US-based networks.

Mir was not the only domestic measure taken by Russia. The Central Bank of Russia also developed a domestic financial-communications platform, the System for Transfer of Financial Messages (SPFS). SPFS was an alternative to SWIFT to prepare the country for any future bans of its largest financial institutions from international transactions.

> "Mir was not the only domestic measure taken by Russia.
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Further evidence of this preparation can be seen through Russia's decision to manage its overseas payments through SPFS in non-Western currencies and its Central Bank's target to increase SPFS's usage rate by 30% in 2023.

All these actions were part of Moscow's overall efforts to develop homegrown financial tools to mirror Western ones, protecting the country in case penalties against Moscow were broadened. And that is indeed what has happened this year.

The Russian payment ecosystem has been seriously impacted after the invasion of Ukraine but some of the damage has been offset

Unprecedented Western sanctions have been imposed on Russia so far this year and effectively cut it off from the global financial system. Thanks to its domestic payment set-ups, the country managed

to mitigate some of the significant anticipated impacts.

After Russia invaded Ukraine on 24th February 2022, the ICS took actions. Visa and Mastercard blocked Russian financial institutions from their networks in response to government sanctions on Russian entities.[2]

On 6th March 2022, American Express (Amex) said it was also suspending all operations in Russia and Belarus. With international card networks pausing their Russian operations, local consumers could no longer use their Visa, Mastercard and Amex single-branded cards domestically or abroad. Foreign customers were also blocked from making payments to Russian companies or withdrawing cash within the country.

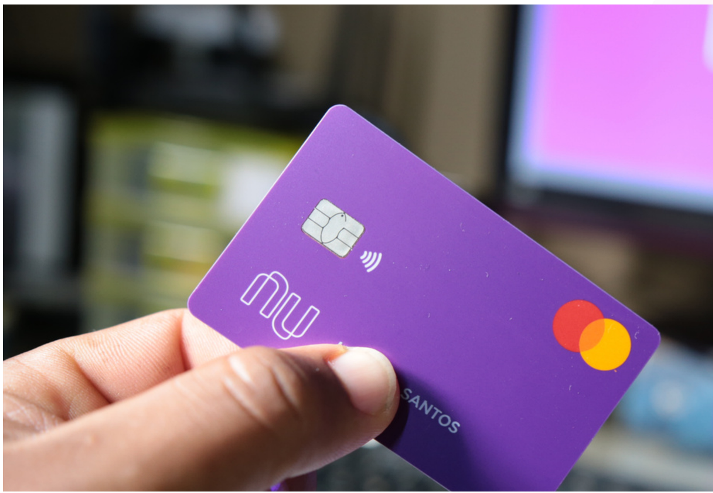
> "With international card networks pausing their Russian operations, local consumers could no longer use their Visa, Mastercard and Amex single-branded cards domestically or abroad."

Mir-branded cards, however, have continued to work for domestic transactions, including those cards co-branded with Visa and Mastercard. Cardholders are still able to access their funds, make withdrawals and domestic transfers – at least until these bank cards expire.[3]

The ICS's recent actions are expected to accelerate the adoption of Mir cards. According to Mir's statistics, more than half of Russians already owned a Mir card as of September 2021, accounting for 32% of intra-country transaction volume. Mir cards are also accepted in a handful of other countries, including Turkey, Vietnam, Armenia, Belarus, Kazakhstan, and Kyrgyzstan.

The central bank announced that many Russian banks now plan to issue cards co-badged with UnionPay International, which will be accepted in 180 countries, as part of mutual acceptance agreements that date back to 2017.

[2] *Visa, Mastercard block Russian financial institutions after sanctions (cnbc.com)*
[3] *Mastercard and Visa block in Russia does not stop domestic purchases | Banking | The Guardian*

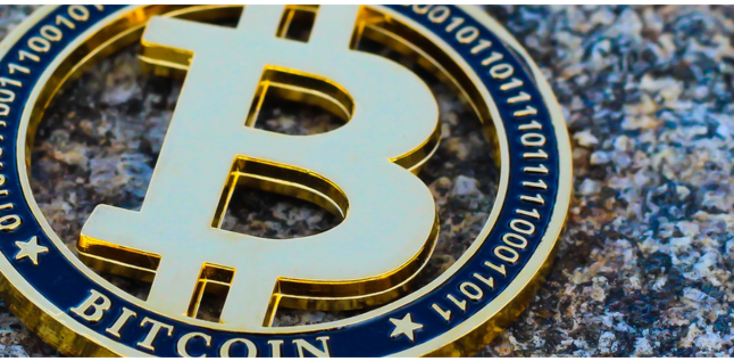


While several Russian banks already co-badge with UPI, large ones, including Sberbank and Tinkoff, could also start issuing the cards.[4] Furthermore, Russia’s SPFS has raised concerns in the international community regarding Russia's ability to counteract the impact of being blocked from SWIFT in the longer term.

Russia has also been affected by sanctions imposed to impact alternative payment methods (APMs) like digital wallets and cryptocurrencies.

Earlier in 2022, PayPal stopped accepting new customers in Russia and suspended its services there. Apple and Alphabet (Google) also cut ties between their digital-wallet services and Mir.[5]

The EU made a move to also ban the provision of high-value cryptocurrency services to Russia.[6]



> "...Russia’s SPFS has raised concerns in the international community regarding Russia's ability to counteract the impact of being blocked from SWIFT in the longer term."

The APM measures were an effort to put pressure on the country’s payment networks since the effect on card transactions was significantly reduced. However, not all technology companies have followed the same path, with Samsung Pay continuing its operations in Russia.

Even though Russia has been able to lessen the impact of the imposed sanctions, its plan for substitution of international cards with Mir-branded cards has been challenged lately. The production of Mir cards has stopped, as the chips for them were produced in Europe or Asia. Asian deliveries have also stopped due to the COVID-19 pandemic, while European deliveries are banned due to sanctions.[7] The chip shortage is posing a significant barrier to Russia’s plans of handling the pressure on payment systems through internal solutions.

[4] *Russian banks may issue cards with China's UnionPay as Visa, Mastercard cut links | Reuters*

[5] *Apple, Google Cut Ties to Russia’s Mir Payment Cards (wsj.com)*

[6] *E.U. Makes Sudden Move Against Crypto ‘Threat’ After The Price Of Bitcoin, Ethereum, BNB, XRP, Cardano, Solana And Luna Made Huge Gains (forbes.com)*

[7] *Sanctions in action: Russia ran out of chips to issue its own bank cards | Global Happenings*

Domestic payment alternatives as a tool to future-proof country interests

The development of domestic payment systems has mainly focused on mitigating the commercial pressure of a low-fragmented card payments market.

However, as shown by the events in Russia over the last decade, they can be an effective tool to decrease the vulnerability and exposure of a country's payment systems to the international community.

Russia took measures to boost the adoption of Mir cards and managed to facilitate widespread adoption by residents and businesses preparing for potential payment sanctions.

This ensured that Russians can now all continue to make card payments domestically and the financial impact of recent sanctions is decreased.

Other country-specific alternatives to SWIFT, like Russia's SPFS, have already gained traction among countries concerned about potential future sanctions and suspensions.

For example, China has developed CIPS, a new interbank payment system, that could represent an alternative to SWIFT. Iran, which was banned from SWIFT back in 2018, and Russia are also coordinating efforts to combine the SPFS system and Iran's financial telecommunications system, SEPAM.

National card networks and payment messaging systems have been shown[8] to reduce third-party dependency and thus increase domestic market independence.

The collective efforts of third-party countries to increase the impact of the imposed sanctions on Russia and the resulting concerns regarding its ability to use domestic payment alternatives as a shield support this statement.

We expect to see an increasing number of countries worrying about the potential penalties of adopting similar domestic payment tools. Finally, in the case of a truce between Russia and Ukraine, it would be interesting to observe the Russian government's response once sanctions are lifted and whether Visa, Mastercard and Amex would resume their operations in the country. Furthermore, would Mir continue working closely with UnionPay International in efforts to reduce ties with the large ICS?

[8] *Russia, Other Countries Abandon SWIFT Payment Network And Establish Alternatives - Russia Briefing News (russia-briefing.com)*

About us

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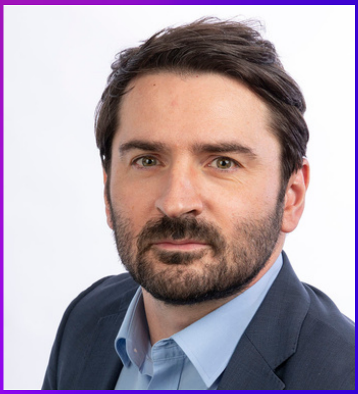

Conchur is a thought leader in the payments industry and a highly-experienced strategy consultant who has led numerous bespoke payments strategy engagements and major payments infrastructure development projects.

During his career, he has worked throughout the payments ecosystem delivering commercial and other business strategies to the leading issuing banks, acquiring banks, issuer / acquirer processors, card networks, PSP / PayFacs, regulators, private equity houses, travel firms and pan-global merchants.

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