Achievable or flawed?

SEPA – the 'Single European Payments Area' concept – seeks to create a single payments infrastructure and architecture for the whole of the eurozone

Rightly or wrongly, Europe's bankers have been severely criticized and penalized for failing to meet the European Commission's vision of a common payments infrastructure for Europe. However, over the past nine months clear indications are emerging that at last bankers plan radical and far-reaching changes to Europe's payments infrastructures.

By Peter Jones

As with many things European, these plans are highly ambitious and have the potential to change permanently Europe's approach to payments processing. However, some argue that these new and important concepts are being formulated with insufficient input from the payment card business and that an opportunity may be missed for radical change.

The stand-off between Europe's banking federations and the Commission has been well documented (*ECR*, Jan/Feb, p30). In 1990, the Commission specified that a low cost and reliable payments infrastructure was an essential element of the future single currency zone. Over the following years banks vacillated, procrastinated and despite many individual initiatives, a common structure failed to emerge.

Even after regulation in 1997 and subsequent codes of practice for retail cross-border payment (RCBP), services did not improve. Costs were still in the order of €20 for a €100 transfer in 2001. This failure to take action drove the Commission and European Parliament to mandate that by mid-2003, fees for cross-border transfers and ATM withdrawals must not be greater than domestic charges. Banks lost some credibility and confidence and now live in fear of further regulation.

So Europe's bankers have been driven to take action. The concept now in the process of formulation has the potential to alter payments structures significantly across Europe. The thinking extends far beyond retail cross-border transfers and seeks to create a single payments infrastructure and architecture for the whole of the eurozone.

The short-sightedness which has long typified the banking sector has been replaced by a strategic vision for all Europe's payments called 'Single European Payments Area' (SEPA), designed to deliver in phases a common infrastructure for domestic and cross-border payments by 2010. This radical idea was conceived in March 2002 by 40 representative banks from the European banking federations and associations.

The underlying perception is that as the eurozone grows, it will become a single homogenous market, where "currency would move freely and cheaply as previously within national borders," in SEPA's words, with 500 million euro- area citizens and consumers making and receiving 100 billion non-cash payments each year. Cross-border transactions will no longer exist, all payments become domestic and citizens can transact "as easily and inexpensively as in his or her home town".

The SEPA vision is constructed on four main pillars:

- Requirements of personal and corporate customers;
- Business frameworks and governance;
- Technical infrastructures, architectures and processes;
- Standards, rules and conventions.

A new body, the European Payments Council (EPC), has been set up to take forward the SEPA concept. Five working parties – Requirements, Standards, Architectures, Cash and Cards – have been formed to review in detail the construction of a common approach to payments in Europe. Committee members have been drawn from banks, ACHs and other interbank bodies. The ambitious target is to deliver detailed architectures and plans by March 2003.

The EPC also claims that some of the core central foundations of SEPA are already emerging. STEPS 1, a retail cross-border transfer service already provided by the European Banking Association, is to be supplemented by STEPS 2 in mid-2003, a bulk regular payments service to be delivered in conjunction with SIA of Italy as part of the redevelopment of its domestic ACH.

In addition, Visa has launched Visa Direct, an account-to-account transfer service which will enable cross-border payments using the internet and P2P concepts. Similar offerings are expected from MasterCard.

However, as they consider SEPA the EPC working parties have to review several fundamental business and technical issues, many of which are politically explosive and potentially damaging to existing domestic payments processing operations.

SEPA itself (Table 1) contains a mixture of strengths and weaknesses. Though such a bold concept will take time for bankers to assimilate, the reaction has been cautious. Supporters argue that SEPA has to aim high if it is to gain widespread support across the EU. Euroland has a common currency and thus a strong case can be made for ➥

1: Analysis of Scope of SEPA Vision

Strengths	Weaknesses
• All embracing • No exclusions • Payment system for EU • Common standards • Common governance • Adopts the TARGET model • ACHs for non-ACH countries • Economies of scale	• Current structures work • Little benefit to customers • Over reaction to EU • High cost and high risk • Political mine field • Another talking shop • Poor business case

common payments standards, processes and governance.

TARGET has proved the effectiveness of a high value central settlement system. There appears to be no reason why the same principles should not apply to retail payments. Supporters also argue that under the current strategy, each country builds and supports its own costly domestic infrastructure and ACH. This model will be unrealistic and uneconomic when EU membership grows to 25 or more countries.

However, many question the breadth of the SEPA vision. Why are both domestic and cross-border payments included? What evidence is there that SEPA is driven by customer demand? The vast majority of consumers and corporates are happy with the current domestic ACHs and would see little or no benefit from a changed structure. Sceptics emphasise that the Commission only mandated cross-border payments and these represent <2% of domestic volumes.

Domestic ACHs and the payment card networks have not been criticized, no doubt because both operate effectively and at low cost. Cynics also suggest that ACH processing was included because only with domestic volumes could very low cost cross-border transfers be achieved.

Some also argue that the project is extremely high risk and politically dangerous. A similar interbank exercise conducted in 1992 only delivered limited ACH linkages no one has used.

A second issue relates to the inclusion of payment card schemes within the SEPA framework (Table 2). Payment cards have the greatest cross-border usage. In several domestic markets they are the primary method of transacting payments.

International card schemes have worldwide standards, a complete end-to-end business and technical framework, as well as highly robust and low cost central clearing and settlement processes. It is difficult to conceive a business case to replicate these massive networks just for the Eurozone. Some suggest that SEPA is a final attempt by the wholesale/correspondent proponents to influence the direction of Europe's payments and to avoid ultimate domination by the payment card business and process model.

However, the payment card business is not without its faults. In some countries single gateway structures (such as "CB" in France) constrict the reach of the international schemes to individual banks in each country. Several domestic debit card schemes still do not use international PANs on the face of the cards, limiting EU-wide account to account transfers.

Many domestic schemes do not operate structured chargeback processes (an important component of consumer redress) or offer full merchant support and accounting. Processes for managing bill payments mandates also need to improve and are still behind UK BACS amendment and cancellation facilities. In addition, several do not enable cross-border usage at the POS. Some also argue that the international schemes operate as supra-national institutions and are outside the central control and governance rules of Europe's payment institutions.

2: SEPA to Develop Common EU Plastic Card

Strengths	Weaknesses
• EU ownership of infrastructure Common framework • Common governance • Improved control	• Current infrastructures highly efficient • Very high cost and risk • No business case • New services on offer (Visa Direct) • No support to change

The third issue, is that of SEPA architectures (Table 3). In November 2001, the ECB published a discussion paper which outlined four potential architectures, including ACH linkages and a single EU ACH. SEPA's architecture has yet to be published, but the general impression is that the preferred route is that of a pan-European ACH or PEACH.

A PEACH would deliver very substantial benefits. Massive volumes would result in costs that could be fractions of a euro-cent, potentially reducing costs by as much as 90%. Many of Europe's domestic ACHs are ageing and several are in need of extensive redevelopment, while three countries do not yet have ACHs. Thus banks in many countries will face high redevelopment costs for their domestic ACHs (*ECR*, Sept/Oct 2002, p25).

A growing number of powerful pan-European banks, like Nordea, SEB, Citibank, Deutsche and others, face multiple redevelopment costs because of their multiple ACH membership. For these banks a single investment in PEACH could make substantial savings and makes good business sense. This will increasingly become an issue as Europe's banks merge and consolidate.

Similarly many of the largest ACHs have surplus capacity, waste resources and mean that many European customers pay unnecessarily high transmission costs. Fewer ACHs would reduce capacity and match supply to demand.

However, the PEACH architecture has potential downside, some critics suggesting that SEPA really means 'Seriously Expensive Payments Architecture.' As a single provider, PEACH would become a central utility operating without competition. Banks could lose control or have to accept very strong price regulation.

For many countries, loss of control of their domestic ACHs and national clearing and settlement would be a great concern. The establishment of the ECB has already undermined the role of national central banks. Loss of con- ➥

3: Strengths and Weaknesses of PEACH

Strengths	Weaknesses
• Economies of scale	• Single solution
• Eliminates duplication	• No competition
• Drives consolidation	• High cost and risk
• Reduces ACH redevelopment	• Residual ACH processes
• Reduces pan-EU bank costs	• Strong national resistance

trol of the domestic payments systems and governance would, for some, be very damaging. The recent purchase of 17.5% of PBS (inter alia, Denmark's ACH) by Danmarks Nationalbank, the Danish central bank is perhaps an indication of future central bank strategies.

Fourth, and last, is the issue of the business case to invest in SEPA and PEACH. On the benefits side, there should be substantially lower central operational costs, improved efficiency and the elimination of duplicate processing. Long-term total capital and investment costs will be reduced. PEACH will serve non-ACH countries and new EU members as they join. In addition, a modern, well-designed ACH should enable value-adds able to generate additional revenue.

However, central costs represent <15% of the end-to-end cost of electronic transmission, so the impact of PEACH's lower costs on banks' total transaction costs could be small. Also, ACHs and individual banks are at different stages of development. Some are just about to invest in new systems, while others have new developments in the pipeline.

All will expect a payback on their investments and will be reluctant to accept the high cost of interfacing and migrating to PEACH until they are realized, which for some could be seven to 10 years. In addition, many ACHs operate several payment systems within one entity (Eftpos, electronic payments, cheque-clearing and RTGS). Removal of some ACH functions would not eliminate all domestic costs so the benefits of PEACH would be marginal.

So is SEPA a credible concept or not? Despite its potential flaws can Europe's bankers make it work? What factors do the EPC need to consider to make SEPA a success?

The weakest and least credible component is an architecture based on a single central solution for the whole of the eurozone. A much better strategy is to encourage a small number of providers to compete actively, but with all operating to common standards. A credible model would be constructed around five or six very large ACHs:

- Nordic (including Baltics);
- British Isles and Benelux;
- Iberia (Spain and Portugal);
- Germany, Austria and Central Europe;
- Italy and Central Europe;
- France.

All could be linked together either on a peer-to-peer basis or via a central switch.

An alternative, or complimentary option, would be to encourage Visa and MasterCard to compete directly with PEACH and build full ACH functionality into their networks. This would be conditional on both organizations building EU-specific versions of the technology platforms (a concept already planned by Visa) and integrating clearing and settlement into the EU central structures. At the same time, both schemes could alter their commercial frameworks to enable full governance to EU rules and norms.

Next, the business case. It is difficult to understand why banks and ACHs should support the SEPA/PEACH concept. Table 4 below indicates that the impact will be high and the benefits modest. At this stage, the SEPA business case needs strengthening.

However, the payment card schemes' EMV business case can be similarly criticized in countries where fraud is low, but most countries will implement EMV by 2005 because the card schemes have used a powerful interchange incentive and penalty to drive the change. Fail to deliver and it costs banks more and risk increases.

The EPC needs to find similar incentives to ensure full participation. A levy on all non-PEACH enabled transactions could convert into an incentive for those who participate first. One way or another, the EPC has to build a highly compelling ROI proposition to its paymasters to invest in PEACH. Banks must also be convinced that PEACH will deliver and will not fade away or show a poor return like WATCH and GSTPA.??

The approach to payment cards also needs to be revisited. A recommendation to build a completely new payment card infrastructure has little logic, given the high cost of development and implementation, and would find few supporters. On the other hand, the card schemes are essential partners. A possible option would be to ask the international schemes (along with large ACHs and third party processors) to bid to provide PEACH's delivery system.

All the SEPA committees arguably need more input from the payment card sector. A new infrastructure which excludes transaction authorization and chargeback processing and which adopts simple ACH processing would miss an opportunity to add value to existing and new payment instruments. Funds guarantee and interchange have been the key to the success of the payment card model, which, unlike ACHs, is profitable and delivers positive revenues to all parties.

So are Europe's bankers embarking on an ambitious and radical venture, or is this a well-orchestrated public relations campaign and spin to satisfy

4: SEPA/PEACH Impact Analysis

Players	Business Impact	Technical Impact	Lower Fees/Costs	Buy Into Concept	Improved Domestic Service	Improved cross border Service
Consumers	●	●	●	●●●●●	●●	●●●●
Corporates/SMEs	●●	●●	●●●	●●	●●	●●●
Banks	●●●	●●●●●	●●●●	●●●	●	●●●●
ACHs	●●●●●	●●●●●	●●●●	●	●	●●●
International Card Schemes	●●●●	●●●●	●	●	●	●

theCommission and European Parliament that something is happening? Will the EPC turn into a talking shop only with banks decommitting when asked to fund the venture? Last, why must Europe completely change its payments structure just to reduce the cost of <2% of transactions?

On balance, the indications are that this time banks will commit. In the end, Europe-wide ventures proceed on a pragmatic basis. Since banks make decisions out of self-interest, a key driver for SEPA/PEACH will be the commitment of a small group of bankers to the concept and not necessarily the bottom line of the business case. So we must expect major change, but the final framework may be substantially different from that currently proposed.

Europe may be about to miss a once in a century opportunity. Perhaps the current SEPA thinking is flawed and its true starting point should be a concept aligned more closely to the payment card model, not ACH or RTGS.

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