

SEPA – An Achievable Vision?

SEPA – the ‘Single Euro 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 criticised for failing to deliver the EU Commission’s vision of a common payments infrastructure. Over the past nine months clear indications are emerging that bankers plan far-reaching changes. As with many things European these plans are highly ambitious and have the potential to alter permanently Europe’s approach to payments processing.

The history behind the stand off between Europe’s banking federations and the EC is well known (see ECR Jan/Feb 2002 pg.30). In 1990 the Commission specified that a low cost and reliable payments infrastructure was an essential facilitator of an open and competitive market. Over the following years banks vacillated 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. Charges were still in the order of €20 for a €100 transfer in 2001. This failure drove the Commission and European Parliament to mandate that by mid 2003 fees for cross border transfers and ATM withdrawals must not exceed domestic charges.

The EC intervention has shaken Europe’s bankers who fear further regulation and has obliged them to take action. A new concept is now in the process of formulation. The thinking extends far beyond retail cross border transfers and seeks to create a single payments architecture for the whole of the Eurozone.

The lack of clarity which has long typified the banking sector has been replaced by a strategic vision for all Europe’s payments called **“Single Euro Payments Area”** (SEPA) designed to deliver in phases a common infrastructure for both 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 the Eurozone grows it will become a single homogenous market where **“currency would move freely and cheaply as previously within national borders”**, with 500m euro area citizens making 100bn non cash payments each year. Cross border transactions will disappear, 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, namely:

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

A new body called the **European Payments Council (EPC)** has been set up to take forward the SEPA concept. Five working parties (Requirements, Standards, Architectures, Cash, Cards) have been formed to work out the detail. Members have been drawn from

banks, ACH and interbank bodies. The ambitious target is to deliver detailed plans by March 2003.

Some of the core foundations of SEPA are already emerging. **STEPS 1**, a retail cross border transfer service already provided by the **EBA**, is to be supplemented by **STEPS 2** in mid 2003, a bulk payments service delivered in conjunction with SIA of Italy as part of the redevelopment of their domestic ACH. Visa has launched **Visa Direct**, an internet and P2P account to account transfer service which will enable cross border payments. Similar offerings are expected from MasterCard.

However the EPC working parties have to examine several fundamental business and technical issues. These key issues are reviewed in more detail within the following paragraphs.

SEPA itself contains a mixture of strengths and weaknesses (see Table 1).

Strengths	Weaknesses
<ul style="list-style-type: none"> • All embracing • No exclusions • Payment system for EU • Common standards • Common governance • Adopts the TARGET model • ACHs for non ACH countries • Economies of scale 	<ul style="list-style-type: none"> • Current structures work • Small benefits to customers • Costs and risks • Limited action • Business Case

Table 1 Analysis of Scope of SEPA Vision

Though such a bold concept will take time for bankers to assimilate the reaction has been cautious. Supporters argue that SEPA has to be high reaching if it is to gain widespread EU support. Euroland has a common currency and common payments standards, processes and governance. TARGET has proved the effectiveness of a high value central settlement system. Why not the same for retail payments? Supporters also argue that it is unrealistic and uneconomic for each country to continue to build and support its own domestic infrastructure and ACH, particularly when Union membership grows to 25 or more countries.

However, many question the breadth of the SEPA vision. Why are both domestic (eventually) 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 plastic card networks have not been criticised no doubt because both operate effectively and at low cost. Some also suggest that the project may not succeed for 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 (see Table 2). Payment cards have the greatest cross border usage. In several domestic markets they are also 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 the massive networks just for the Eurozone.

Strengths	Weaknesses
<ul style="list-style-type: none"> • EU ownership of infrastructure • Common framework • Common governance • Improved control 	<ul style="list-style-type: none"> • Current infrastructures highly efficient • Cost and risk • Business Case • New services on offer (Visa Direct) • No support to change

Table 2 SEPA to Include Common EU Plastic Card Infrastructure

However, the payment card business has its faults. In some countries single gateway structures (such as CB in France) constrict the reach of the international schemes to individual banks. Also several domestic debit card schemes still do not use international PANs on the face of the cards limiting EU wide account to account transfers. Several 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 schemes do not enable cross border usage at the POS. Some also argue that the international schemes operate as supra-national institutions outside Europe's payment governance rules.

The third issue is that of SEPA architectures (see Table 3). In November 2001 the ECB published a discussion paper outlining four potential architectures including ACH linkages and a single EU ACH. SEPA's architecture has yet to be published, but the impression is that evolution towards a Pan European ACH or PEACH is the preferred option.

An eventual single ACH would deliver very substantial benefits. Massive volumes would result in costs that could be fractions of a euro-cent, potentially reducing costs by up to 90%. Many of Europe's domestic ACHs are ageing and several are in need of extensive redevelopment (see ECR article Sep/Oct 2002, pg.25). In addition a minority of countries (three) do not yet have ACHs. In addition, a growing number of powerful Pan European banks, such as Nordea, SEB, Citi, 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 (a growing issue as Europe's banks merge and consolidate). Similarly, many of the largest ACHs have surplus capacity, waste resources and means that many European customers pay unnecessarily high transmission costs. Fewer ACHs would reduce capacity and match supply to demand.

Strengths	Weaknesses
<ul style="list-style-type: none"> • Economies of scale • Eliminates duplication • Drives consolidation • Reduces ACH redevelopment • Reduces Pan EU bank costs 	<ul style="list-style-type: none"> • Single solution • No competition • Cost and risk • Residual ACH processes • National resistance

Table 3 Strengths and Weaknesses of PEACH Architecture

However, the PEACH architecture has potential downsides. An eventual 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 would be a great concern. The establishment of the ECB has already undermined the role of national central banks. The recent purchase of 17.5% of PBS (the Danish ACH) by the Danish Central Bank is perhaps an indication of future domestic central bank thinking.

The fourth issue is the business case to invest in SEPA and PEACH. On the benefits side there should be substantially lower central operational costs and improved efficiency. Long term total capital and investment costs will be reduced. PEACH will serve non ACH countries and new EU members as they join. A modern well designed ACH should enable value add able to generate additional revenues.

However central costs represent <15% of end to end costs, so PEACH's impact on total costs could be small. Also, ACHs and individual banks are each at different stages of development. Some are about to invest, others have new developments in the pipeline. All will expect a payback and will be reluctant to accept the high cost of interfacing and migrating to PEACH until they are realised which for some could be seven to ten years. Many ACHs operate multiple payment systems within one entity (EftPos, ATM, electronic payments, cheque clearing and RTGS). Removal of some ACH functions would not eliminate all costs so the benefits would be marginal.

So is SEPA credible or not? Can Europe's bankers make it work? What is needed to make SEPA a success?

The least credible component would be an architecture based on eventually a single central solution. Much better to encourage a small number of providers to compete actively but with all operating to common standards.

A credible model would be constructed around 5-6 very large linked ACHs:

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

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

Another alternative, or complimentary option, would be to encourage Visa and MasterCard to compete directly with PEACH and incorporate full ACH functionality into their networks. This would be conditional on both building EU specific versions of the technology platforms (a concept planned by Visa) and integrating settlement into the central EU structures. Both schemes could alter their commercial frameworks and set up EU specific entities to enable full governance to EU rules.

Next the business case. It is difficult to understand why banks and ACHs should yet support the SEPA/PEACH concept. Table 4 below indicates the impact will be high and the benefits modest. At this stage the business case needs strengthening. However, the payment card scheme's Chip/EMV case can be similarly criticised in countries where fraud is low, but most countries will implement EMV by 2005 because of interchange incentives and penalties. Fail to deliver and costs and risks increase.

The EPC needs to consider similar incentives to ensure full participation. A levy on all non PEACH conforming 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 for its paymasters to invest. Banks must also be convinced that PEACH will deliver and will not fade away or show a poor return.

Players	Business Impact	Technical Impact	Lower Fees/ Costs	Buy Into Concept	Improved Domestic Service	Improved Cross Border Service
Consumers	•	•	•	••••	••	••••
Corporates/ SMEs	••	••	••	••	••	••••
Banks	•••	•••••	••	•••	•	••••
ACHs	•••••	•••••		•	•	•••

Table 4 SEPA/PEACH Impact Analysis

The approach to payment cards also needs to be revisited. A recommendation to build a completely new plastic card scheme and 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.

The SEPA committees arguably may need to examine more clearly the payment card model. A new infrastructure that excludes transaction authorisation 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 payment card success which delivers positive revenues to all parties.

So are Europe's bankers embarking on an ambitious and radical venture, or are we observing a public relations campaign to satisfy the European Commission and Parliament? Will the EPC turn into a talking shop with banks decommitting when asked to fund the venture? Last, why must Europe at great expense, completely change its payments structure to reduce the cost of <2% of its transactions?

On balance the indications are that banks will commit. In the end European wide ventures proceed on a pragmatic basis. Since banks make decisions out of self interest, a key driver for SEPA will be the political commitment of a small group of bankers. So we must expect major change but the final framework may be different from that currently proposed.

Europe may be about to miss a once in a century opportunity. Perhaps the current SEPA thinking is too narrow and that a concept that uses the best features of the plastic card model, ACH and RTGS is the way ahead.

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