Single Euro Payment Area (SEPA)
Refocusing the aim to achieve genuine across-the-board involvement

The aim of the European institutions is to establish an "integrated market for payment services which is subject to effective competition and where there is no distinction between cross-border and national payments within the euro area"[1]. Three payment instruments are concerned[2]: direct debits, credit transfers and debit cards. The process will take place in two stages: on 1 January 2008, euro area banks will start to provide users with the SEPA compliant euro payment instruments designed by the European Payments Council (EPC),[3] i.e. pan-European direct debit and credit transfer. By end-2010, the SEPA payment instruments are due to replace permanently all former domestic instruments.

1- 2008: a realistic technical deadline for banks
(see Annex I)

As a result of extensive work by the banking industry, EPC-defined direct debits and credit transfers will be available domestically and on a cross-border basis as from 2008. In order to create the required legal certainty, the draft of the EC Payment Systems Directive should also be adopted by that date. The market needs this Directive to ensure the European-wide legal basis for relations between participants, especially with regard to the new SEPA direct debit product. Regarding payment cards, the EPC has set the compliance requirements for schemes and payment service providers that want to provide services across the SEPA. These requirements can be met in various ways, allowing individual banks to choose the option that suits best their needs.

The introduction of SEPA compliant products will provide various benefits to end-users and providers, including standardisation of the execution time for cross-border credit transfers, a new pan-European direct debit product and a migration towards pan-European payment infrastructure standards. This standardisation will allow and encourage technical convergence of national systems. The timetable for this will be largely driven by national considerations related to the economics of the incumbent infrastructure (e.g. level of obsolescence or economic efficiency, possible pace of investment). It is expected that the number of payment infrastructures will reduce gradually – currently in excess of 25 – resulting, in the longer run, in a cost reduction for the providers of payment instruments. Multiple adjustments will be needed for systems, banks and their customers. At present, very few entities (utilities, government departments) believe that they will be able to make the necessary technical adjustments by 2008 as a result of the extensive efforts involved. In the end, it will be mainly market forces that will drive the move towards a more integrated and standardised payments environment.

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[1] *Consultation Paper on SEPA Incentives*, 13 February 2006

[2] Most payment instruments cannot be used – or used as efficiently – in more than one Member State. Cross-border direct debits are impossible; timeframes for cross-border credit transfers vary considerably; national debit cards cannot be used outside the holder's home country; and the legal rules governing payments vary from one country to another.

3 Formed in 2002, the EPC is an interbank organisation composed of some fifty EU banks and three industry groups: the European Association of Cooperative Banks, the European Banking Federation, and the European Savings Banks Group.

2- **By contrast, the 2010 deadline is causing deep concern in national banking industries** (see Annex I)

The €122 billion of economic benefits expected by the Commission are questionable (see Annex II)

Aside from annual savings of €10 billion from technical standardisation at European level and from infrastructure consolidation, €100 billion will be generated through e-invoicing. However, it is companies, not banks, which will mainly be concerned with implementing this project since it affects their financial and commercial relations with customers. That said, the European payment instrument standards currently under development are capable of conveying the data needed for e-invoices.

A further €6.7 billion of savings is claimed to be possible by harmonising charges for payment instruments across Europe. However, converging to a single average level of charges would entail an increase for consumers and/or merchants and utilities in certain countries – between €60 and €75 per person per year in France and the Netherlands, according to some studies. On the other hand, converging to the lowest level of charges is equally problematic as it would generalise the subsidisation of certain payment instruments, which has been occurring in some "lower-cost" countries for many years.

The project has been launched without first stabilising the economic dimension of relations between banks

Multilateral interchange fees (MIFs) sit at the heart of payment systems and in particular of every four-party card system. National interchange fees reflect the economics and dynamics of each individual market. Given the divergence among European countries in terms of legal and political climate, and the varying maturity of the payments market, national interchange fees reflect these differences. It must be expected that, as and when markets become equally mature, interchange fees will start to converge. In order for this to happen in a manageable fashion, the Commission must establish a common legal basis for interchange as a concept. The current situation, whereby in more than 10 European countries national regulators are dealing individually with the issue, must come to an end. Any attempt to harmonise interchange across Europe without having solved the legal discrepancies among countries will create huge distortions in the payments market, to the detriment of the end users.

Economic uncertainties are hampering the momentum needed to achieve the 2010 objectives

Economic uncertainties are holding back the momentum needed to replace domestic instruments by European ones. Unless the business case for direct debits, credit transfers and payment cards is built and stabilised, banks and users (merchants, government departments, utilities) will be unable to commit the requisite technical and commercial investments.

Furthermore, if banks were unable to make reasonable profits from payment instruments, they might well withdraw from this activity. As a result, competitive product offerings would disappear and be replaced by standardised low value-added instruments. Likewise, the trend towards decreasing use of the least efficient payment instruments would stall.

3- Another vision for 2010

Most of the benefits of the single payments area stem from dematerialisation and technical standardisation. Applying a single set of standards to different payment instruments allows reducing the number of infrastructures and makes it easier for banks to access other domestic markets. Dematerialising payment instruments in Europe will be achieved by adopting instruments that are more efficient and safer than cash and cheques. According to European Commission estimates, cash accounts for two-thirds of the costs engendered by all payment instruments in Europe. All payment system participants will benefit from the adoption of these instruments thanks a reduction in crime (assault, fraud), a decline in handling costs and a reduction of the “grey” economy.

Critical success factors

The investments to create and launch the SEPA payment products must be economically viable and sustainable. These investments must be committed according to a timetable that takes into account the technical obsolescence and the expenditure programmes of users, banks and local infrastructures.

Furthermore, banks must be able to make a profitable margin on the provision of payments. The legal conditions governing the pricing of payment services, at interbank level and to end-users need to be stabilised, as quickly as possible, in light of the 2010 deadline. The European Commission's sector enquiry highlighted a need for clarification in the area of MIFs. As mentioned previously, the Commission must create a stable legal framework in order to establish the required stable basis for all system participants in the area of interchange. Maybe, this is the time for all stakeholders involved, to discuss and agree a comprehensive framework that provides an equitable distribution of costs and benefits of the various payment means, resulting in a substantial reduction of the least efficient payment means like cash.

A SEPA committee comprising stakeholders and public authorities must be set up in each SEPA (25+4) country to organise the implementation of SEPA payment instruments. These committees are also needed to ensure that the process of dematerialising retail payments follows a master plan tailored to each member state. This is important since countries have historical reasons for using various payment instruments.

The committees should also determine the appropriate pace for adopting the new standards, based on the degree of obsolescence and the efficiency of domestic infrastructures and, more generally, stakeholders' investment capabilities.

None of this will be possible without the involvement, not only of banks, but also of users and political leaders. Politicians in particular must provide the impetus for government departments to adopt the new instruments and must provide incentives to persuade consumers to use the most efficient instruments.

In addition, efforts to achieve standardisation must be increased. Broad-based technical harmonisation is needed to consolidate infrastructures properly. Next to credit transfers and direct debits, attention must also be given to other domestic payment instruments, especially business-to-business payments. Standardisation must be done by taking existing European norms as building blocks and adapting them. Also, to reach this goal, the work being done on standardisation in the field of credit/debit cards (EMV) must be taken further, particularly in the fields of acquisition, clearing and authorisation.

4- Tangible, compelling benefits for users

European consumers are broadly content with their domestic payment instruments at the moment. As from 2008, they will benefit from more standardised execution times for credit transfers in Europe, together with a pan-European direct debit, which does not exist at present. What is more, cardholders will be able to use their cards at more locations in the euro area.

Eurofi believes that by 2010 the real benefits for consumers, companies and governments will come mainly from greater use of electronic payment instruments rather than from efforts to seek unified European payment instruments. In addition, the first steps towards infrastructure consolidation, made possible by the market-driven implementation of technical standards, will deliver economic benefits to providers and to users.

In summary, the only way to achieve convergence within the SEPA area is through competitive forces, gradual convergence of transaction processing, and the increased use of electronic payment instruments. Convergence will require discouraging the use of inefficient instruments and increasing technical standardisation across the value chain. This major effort will demand the involvement of and co-operation among all participants: banks, utilities, merchants and government departments, as well as national and European political authorities.

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Annex I

SEPA: impacts underestimated, particularly for consumers, and political impacts poorly managed

Eurofi-affiliated banks agree on the necessity to organise the convergence of payment instruments and infrastructures at EU level on the basis of SEPA technical rules and standards.

However, the concerns expressed by banks and the insistence of EU Institutions demonstrate important misunderstandings that are hindering optimal implementation. The need to carry out highly technical work has overshadowed the need to exchange views and agree a common stance on the diversity of the impacts and their effect on the various stakeholders.

In this context, Eurofi's initiative sought to identify the relevant issues, to define and illustrate them and if possible to find consensual ways forward. One of the key success factors in this respect is to build shared understanding, both of common topics, and specific local concerns. This shared understanding should transcend traditional suspicions.

SEPA Credit Transfer and Direct Debit: two vital building blocks requiring determined implementation by bank communities but with appropriate country-by-country adaptations.

At present each domestic payment system, despite significant differences in unit costs, has **needs-based infrastructures**, based on domestic needs and behaviours. It would have been an impossible undertaking to build a "one size fits all" scheme as well as building "the best of breed" scheme. These factors confirm the relevance of the guidance followed by the EPC in building unified SEPA schemes focused on direct debits and credit transfer, and based on a balanced mix of reliability, cost and delivery.

Eurofi-affiliated banks are committed to allow their customers (European citizens) to use, at the beginning of 2008, the key payment services - credit transfers, direct debits, and card payments – to pay in euro everywhere in the eurozone, for their everyday transactions with the same convenience, cost and legal conditions as in their home Country.

Furthermore, benefiting from gains provided by sharing common standards and platforms is an important target for each domestic banking community. Naturally, this will entail **replacing existing local technical rules and standards with SEPA ones** that are now available.

To prevent consumers and corporates from rejecting SEPA payment instruments, it is necessary to preserve the key existing domestic functionalities. Consequently, it is also necessary to **carry out the relevant domestic adaptations** of SEPA standards while maintaining other specific and efficient means of payment.

"Best of breed" approach attractive but not feasible

Applying a "best of breed" approach would have required a simultaneous combination of the highest level of security (and the related investments), the lowest processing costs, which usually means focusing on selected core functionalities, and the shortest execution times. An alternative would have been to develop three complementary schemes, the first focusing on reliability, the second on lowering cost and the third on real time settlement. But there would have been no guarantee that these new products would be successfully adopted by end users.

Moreover, in many markets credit transfers and direct debits are already managed and processed in a very efficient way. It is very difficult, if not impossible, to explain to a consumer in such countries what the benefits will be. Apart from the fact that he will have to adopt BIC and IBAN also for domestic payments, which will mean a change of old habits, not a benefit.

Furthermore, gathering all the existing volumes would require incorporating not only credit transfers and direct debits but also, for example, the credit facilities that, in some countries are supported by payment instruments (RIBA, LCR, etc.). This would create excessive complexity.

Finally, basing these new SEPA technical rules and standards on the very latest technologies would not make it possible to maximise security and reduce costs. For example, the XML standard requires higher communication costs, while the Internet still creates security concerns in legal and technological areas.

As a consequence, only a **pragmatic rollout of SEPA technical rules and standards will achieve the desired effect**. This necessarily consists of a progressive country-by-country roll-out strategy with, a **determined adoption of existing SEPA building blocks** (in the same way that Eurozone countries adopted Euro notes and coins), and an **adaptation to the critical local requirements** (as each country has preserved or developed, after euro notes and coins adoption, its own rules for cash transportation and recycling).

SEPA standards offer the opportunity for implementing STP strategies, provided corporates handle the related standard-setting

As end-to-end straight-through processing promises huge savings, European financial processing is not solely a banking industry issue. It necessarily involves corporates and merchants too. The traditional distribution of roles puts banks both in a clearing and settlement role, and in message transportation, while corporates assume responsibility for standardising the invoice message format. In this area, corporate-led working groups have been meeting for years, but little progress has been made so far (except recently in Finland), bearing in mind that larger groups had developed proprietary standards with their usual partners.

SEPA standards propose four 35-character zones allowing information transportation; the banking community can also commit to ensuring message integrity.

It is up corporate professionals to structure standards in order to take advantage of STP either by using this existing possibility or by specifying other requirements.

The huge technical investments, workflow and consumer protection impacts introduced by the adoption of SEPA standards require joint efforts from all stakeholders, and broad-based communication

In any case, implementation of SEPA will create significant impacts for all users. It will involve investments and important changes. Technical investments will be borne by corporates, merchants, public administrations and banks. Preliminary evaluations have demonstrated the importance of the effort to be made.

But it should be remembered that the changes in role-sharing along the payment value chain will also lead some entities to create new administrative departments, while others will be making redundancies (for example in France, banks will no longer ensure custody mandates). Finally, even slight changes in product functionalities or in consumer protection will generate increased customer complaints and enquiries.
This situation needs a joint communication drive before, during and after the introduction of SEPA standards: communication aimed at national policy makers to inform them about the target, the expected impacts and the positive overall balance; communication aimed at consumers or domestic users who, unlike large or international users, will only perceive a positive impact over time, through a gradually expanding offer (new market entrants) and lower prices.

The situation requires a joint effort that should not be borne solely by banks. Overall communication policy must be initiated, organised and funded by all the key stakeholders, as well as by national and European Institutions. In particular, public administrations must play an exemplary role by adopting SEPA schemes but also by enhancing the use of electronic payments for many public services that still using costly paper-based payment instruments.

The opportunity to establish a European Commercial framework

The European Commission is stressing key importance of creating SEPA (payment costs are equivalent to between 2% and 3% of GDP). It has pointed to the percentage of these costs that is attributable to the processing of inefficient payment instruments, especially cash, which accounts for two-thirds of these costs. It is clear, therefore, that one of the key challenges in creating SEPA is the shift from current inefficient payment methods towards electronic (SEPA) payments instruments"

The success of a substitution strategy hinges on applying a complex set of complementary levers – the so-called commercial framework, which banks are thoroughly familiar with. The main components of that framework are:

- a fair, acceptable and balanced distribution of costs and benefits among end users (consumer/corporate; consumer/merchant; consumer/public services, etc.)
- bank revenues being used to finance the technical and commercial development of payment schemes

- appropriate and consistent linkage of fees for all payment instruments and the related banking services (especially current accounts)
- a system of bank charges that ensures competition and transparency
- a determined drive to adopt electronic payment instruments in new transaction areas (e.g. public services) so as to provide a practical underpinning for the policy of financial incentives

However, all banking communities clearly understand the reasons for inadequate national changeover: legal obligations, habits, political issues and difficulties in explaining additional fees to consumers, investments to reduce the cost of inefficient payment means, but also cross-subsidies between either current-account cash balances or efficient and inefficient payment means, etc.

For this reason, the development of substitution strategies must start with a precise analysis of the situation in each country. This should include the lessons learned from previous initiatives and the traces these have left on various stakeholders, especially consumers. The involvement and accountabilities of the stakeholders must also be carefully organised.

Full reachability as a prerequisite for effective competition between SEPA infrastructures

Effective competition between two scheme infrastructure providers supposes that each is able to offer similar clearing and settlement possibilities to all end users for similar payment situations. This requires access to full Eurozone reachability. To avoid an expensive solution consisting of requiring all Eurozone banks to join all competing SEPA scheme infrastructures, two solutions are being envisaged: either interconnecting all local clearing mechanisms or opening the full reachability set up for EBA in all EU countries to all competitors.

The best solution must be chosen rapidly: as long as uncertainty remains, the best attitude for domestic infrastructures is to adopt a wait-and-see policy, since they cannot either identify the technical interlinking investments required or choose the most attractive PEACH to connect to or to merge with.

Finally, equitable technical and financial solutions to enforce full reachability must be set up soon and in any case before the launch of the SEPA schemes. Because of network effects, the first scheme infrastructure would have an irreversible advantage, and this situation would be unacceptable to the entire banking community, which expects positive impacts from effective competition.

SEPA implementation: a tailor-made country-by-country programme in which national policy makers are closely involved

After the design phase, SEPA has now reached the implementation phase.

Optimising the balance between efforts and investments, on the one hand, and maximising the expected positive impact, on the other hand, requires setting up country-by-country strategies, based above all on an accurate assessment of traditional evaluations of costs, the potential impacts on the current habits and organisations, the fee shifts, and so on. This applies to all significant stakeholders: small, medium and large merchants and corporates, public administrations, local and multinational banks, and last but not least, consumers.

National policy makers need to be closely involved in these huge changes because they will have to endorse them. This will also encourage early adoption by public administrations.

Annex II

SEPA–figures: what is at stake behind compelling financial-benefits assessments?

European Institutions seek four specific positive impacts from EU payment integration.

1. End to end straight through processing of invoices (so called e-invoicing)
2. Product standardisation and infrastructure consolidation (driven by common SEPA standards)
3. Price discrepancies reduction (which higher competition is expected to facilitate)
4. Increased usage of electronic payments (thanks to the attractiveness of the SEPA payment means and cost-based pricing)

The European Commission estimates [4] the related financial benefits in the annex 4 of the Consultative paper on SEPA incentives as follows:

1. Invoice end to end straight through processing — extra cost B€ 100.0/annum
2. Product standardisation & infrastructure consolidation — extra cost B€ 10.0/annum
3. Payment account prices (vary by factor 1:8) — extra cost B€ 6.7/annum
4. Increased use of electronic payments — extra cost B€ 5.3/annum

E-invoicing: the largest financial impact – In this respect SEPA technical standards are effective enablers to be leveraged by corporates

E-invoicing, as estimates by the Commission, is by far the largest benefit (€100 Billion/annum). Invoicing is one of the most important commercial and administrative processes in customer/provider relationships. It is an extension of ordering and receiving goods. It initiates and structures accounting, tracks delivery, and impacts tax calculation…

The payment process can usefully complement those complex processes, transferring key information from the customer to the provider. Existing SEPA technical standards already allow transporting through payment systems 4x35 characters. Leveraging this possibility among customer and provider invoicing processes requires important developments, driven by both front-ends of the invoicing value-chain. It must be a project managed in parallel to the other SEPA projects. Standards setting in this area should not be under the responsibility of banking communities but be driven by corporates in the first place.

Product standardisation and infrastructure consolidation: EMV and SEPA technical standards are important steps forward but tangible and intangible implementing costs for the users should be accurately assessed

Domestic and cross border payment schemes are based on two main pillars: on one hand, commercial, financial and legal inter-bank-agreements, and on the other hand

[4] The figures Eurofi comments in this paper are those usually used by the Commission coming from two studies: McKinsey (2003) and Gemini (2004). Eurofi has not challenged the related methodology.

technical standards. Potential cost savings up to B€ 10.0/annum are driven by the technical side of things.

In this respect, the roll out of SEPA technical standards must be considered as an important step. Indeed, SEPA technical standards offer key technical building-blocks for cross-border and domestic euro payments, (direct debit and credit transfer). Those standards complement EMV card standards, currently being rolled out throughout Europe.

Nevertheless, an accurate cost assessment integrating actual tangible and intangible investments costs required from banks as well as merchants, corporates and consumers, to implement SEPA standards, is required to check the reality of a favourable cost benefit ratio.

It is also appropriate to identify what should be the next steps for further standardisation in order to really catch all the potential benefits.

Prices-discrepancies reduction: an idealistic ambition ignoring current domestic historical payment-prices and costs balances between customers, merchants and corporates, and banks, and bringing intolerable financial shifts for all the stakeholders

The reduction of price discrepancies (€6.7 Billion) could be achieved by the substitution of local pricing schemes by a single European pricing scheme, either

- Making all the countries to converge to the current lower European price-level on both consumer's and merchant and corporate sides;
- Or making all the countries to converge toward a price level somewhere between the extremes.

Indeed pricing diversity is huge throughout Europe. But one has to consider that at the same time, from one country to another, the balance between revenues generated from consumers and revenues generated from business is very different in each market. In the same way efficiency and profitability of those activities are very diverse. That makes a convergence to similar pricing levels very problematic.

Firstly, convergence to a common price level, intermediate between the current EU extremes, is just not feasible. For example converging to the current EU price-level average would produce huge financial displacements: Italian and Spanish banks would respectively destroy 12% and 29% of their payment revenues on the consumers side (B€ 5.4 and B€ 1.3) entailing serious competitiveness threats to domestic banks; in France or in The Netherlands consumers would at the same time pay respectively 19% and 30% more for their payments (B€ 3.7 and B€ 1.2), precisely 62€ /capita/annum in France, and 75€ /capita/annum in Netherlands[5].

But converging toward the lowest EU price level on both the consumer and business side is idealistic. For example, in the UK or in The Netherlands, where banks earn up to 70% of their payment revenues on the business side, applying the lower EU price level would mean further profitability reduction for those two countries where payment

[5] Based on a population of 60 million in France an 16 million in Netherlands

profitability is already marginal, despite already cost-effective industrial arrangements. In this case, price increases on the consumer side would be inevitable.

These examples illustrate that current domestic pricing results actually from historic evolution and constitutes a balance between earnings and costs, benefits and losses, and this for each payment means and each customer segment is separately. It also illustrates that low prices do not always go together with payment process efficiencies.

If SEPA would result in price increases up to €75 per annum per customer, SEPA may not have, neither a business, nor a political case. Actually it could become a political nightmare. Indeed, several questions must be asked in relation to the current price discrepancies:

- Beyond local heterogeneous price-levels what are the related actual industrial efficiencies and beneficial capacities
- What process is required to establish a comprehensive and balanced commercial framework for the pricing of the new SEPA products?
- What bank will adopt such European poorly attractive scheme for its domestic payments?
- What could be the consequences on the introduction of such poorly attractive new pricing models for electronic payments (likely increased use of cash and cheques)?
- How to explain to consumers, merchants or corporates, domestic banks… such potential shifts in pricing approach?

Increased use of electronic payments: EU ambitions actually do not take into account former domestic efforts, the business case issues and key success factors assessment

€5.3 Billion identified in the Commission "SEPA incentives" paper as "**excess costs to be cut",** are in reality the estimated amount of the **banks profits** generated by a shift from cash towards more electronic payments. This amount is not only the reduction of the cash handling costs incurred by banks, but also the increase of the revenues from cash (increase of related fees to dissuade individuals to use cash) and the increase of the costs and the revenues related to a larger use of electronic payments.

In other words, this expected benefit, obviously attractive for banks in some countries, may generate additional costs for consumers and merchants. Several questions need to be asked to provide an accurate and more balanced view of the stakes and on the feasibility of an increased use of electronic payments:

- What are the related savings but also the new cost brought by such substitution for retailers and corporates? Cash fixed-cost effective decrease? Increased electronic-payment fees paid? Customer marketing investments?
- What are the actual additional potential, and the related business case, in countries which have already reached a high proportion of electronic payments?
- What is, on the consumer's side, the prerequisite to reach the expected effect, in particular the introduction of cost-based fees for cash and cheques…?

- Who will endorse the tough domestic political case for those price changes?
- What are, country by country, the lessons to learn from past attempts to develop electronic payments? How to ensure higher success?

Conclusion: among the €122 Billion benefits estimated by the Commission, only the €10 Billion originating from the introduction of SEPA standards are credible

At this stage we may conclude that:

- Among €122 Billion estimated by the Commission, €100 Billion suppose an important effort from corporates to leverage the possibilities brought by SEPA technical standards (e-invoicing);

- Among the €22 remaining Billion, the only credible benefits, are those brought by product standardisation & infrastructure consolidation (€10 Billion) e.g. implementing SEPA standards, if it can be confirmed that the required investments expected from consumers (changing their habits), merchants and corporates, and banks make it attractive enough;

- Ambitions related to fees unification (€6.7 Billion) appear unrealistic because of the delicate political issues related to it;

- Efforts to substitute inefficient payment means like cheques and cash must obviously be pursued. Those efforts are not to be undertaken by banks alone, but must be a shared effort between all the stakeholders. That effort should be organised on a country-by-country basis as each country has a specific sensitive history in this area. Finally, the related expected benefits still must be re-assessed, including tangible and intangible costs and benefits for banks, consumers, merchants, corporates and governments.