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The Secretariat

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LIMITE

NOTE

From : Secretariat
To : FSC
Subject : The Single Euro Payments Area (SEPA)

Please find attached a note by the FSC secretariat on the Single Euro Payments Area (SEPA).

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EXECUTIVE SUMMARY

1. The ECOFIN Council at its meeting on 5th May 2006 stressed the importance of the Single Euro Payment Area and invited the FSC by autumn 2006, together with the Commission, to examine how to best make progress in this field by 2010. The current note aims to furnish a background for the FSC to respond to that mandate by examining the state of play on SEPA by outlining how the Member States can contribute to progress.
2. The aim of SEPA is described as to *foster the integration of the payments market in the Euro area* by removal of the national barriers to payments, that hamper competition and interoperability at the euro area, which will bring substantial economic benefits.
3. SEPA find its *origins* in the introduction of the Euro, when the participating countries shared a currency but where national payments markets remained isolated with largely differing levels of efficiency and cross-border payments were slow and inefficient. The vision for the SEPA was therefore formulated in 2002 when the EPC (the European Payments Council) was created and which decided to launch the Single Euro Payments Area (SEPA). SEPA is more concretely composed by *sets of standards, rules and frameworks* that determine how banks and other payment service providers exchange payment information with each other and thus permit money to move freely between users regardless of where they are situated
4. Section III of the note outlines *the state of play on the constitutive elements of SEPA*, the scheme rulebooks for credit transfers and direct debit and the SEPA Cards Framework, and examines some operational issues of SEPA: namely management and standards. The (proposed) Payment Services Directive is described in the context of SEPA and the state of play on national migration plans is reviewed.

5. Section IV examines, non-exhaustively, some of the main concerns raised by Member States. Regarding the concern that *SEPA could lead to a decrease in service and/or to higher prices in Member States where the service is already high*, the note concludes that although there will be a regular need to update the rulebooks developed by the EPC, much will depend on the actual SEPA products and services developed by banks in competition based on these rulebooks. The matter of service levels and pricing is also highly dependant on the governance of SEPA, and how it will define and develop the products, services and standards. *The public authorities should closely follow the developments and be able to intervene swiftly, if necessary*. These and related issues are raised in the consultative paper of the Commission, dated 13 February, where a number of questions are posed to help the Commission decide what, if any, further actions may be needed to help ensure the success of SEPA¹.

6. The note concludes that the migration to *SEPA need not entail any unnecessary costs* for payment service providers or users but that commitment from Member States to early use of SEPA products, *on the absolute condition that these products are better or at least equivalent to existing products* in terms of price and quality. This commitment is important to encourage payment service providers to invest in the necessary technology. *Nor can SEPA be described as overambitious* in its aim to cover all payments in euro, since it is vital to bring down national borders to payments to allow competitive pressure to raise efficiency levels. The introduction of SEPA as a cross-border payment system only (the "mini-SEPA option") would be both costly and inefficient.

7. It is essential for any effectively functioning market that services and products are correctly priced. However, in a number of Member States, the *true pricing of payment* services is not visible to end users who perceive payments as a free service. Introducing transparent pricing based on the true cost of the instrument may generate public resistance, and a coordinated *information campaign* may be needed to explain to the public the need for transparent prices.

¹ http://ec.europa.eu/internal_market/payments/docs/sepa/sepa-2006_02_13.pdf

8. The *SEPA Cards Framework* raises concerns, because of the *possible effects on competition* resulting from the approach chosen by the EPC. It is important to improve the competitive situation in the market by allowing more schemes to play a role at the European level. Standards need to be developed and be open to all actors so that (at least) all technical barriers that fragment the market are removed. This issue may merit further consideration. The Commission has also expressed concern that competition in relation to the *multilateral interchange change fees*² paid by retailers, may distort competition and may actually lead to raised prices. The Commission is addressing these deficiencies, but this will take some time.

9. The increased interoperability of the SEPA-products, in particular card products, relying heavily on information technologies opening up a wide geographical area, makes them vulnerable to fraud and any known vulnerability could be exploited quickly. Therefore, it might be considered defining harmonised high-level minimum *security requirements* for cards and accepting devices, together with appropriate evaluation and certification structure.

10. Regarding *timing* it seems clear that while the Payment Services Directive will be adopted it may not be fully implemented in Member States before the first SEPA products are scheduled to be available on 1 January 2008. What exactly this would entail for the launch of SEPA is not completely clear, and should be studied further.

11. The support required from Member States is set out in Section VI "Contribution by Member States". First of all, the community legislator must provide *the necessary legal framework*, namely the Payments Services Directive. Secondly, the Member States, as heavy users of payment services, must be *ready to use the new products provided they are equivalent or better than the current national products*, in order to permit the banks and other payment service providers (PSPs) to begin recovering the investments necessary. Lastly, Finance Ministries of Member States should *monitor progress* on SEPA at national level, taking into account also the monitoring activities undertaken by the National Central Banks and *report back to FSC* on progress.

² The fee the customer's bank charges (the issuing bank) when it reimburses the retail price of goods or services acquired by the customer using a credit and debit card, to the bank of the merchant (the acquiring bank).

The Commission could also be invited to *continue its work* on the next steps regarding the issues raised in its consultative paper on SEPA, since the adoption of the PSD alone may not prove sufficient to create an integrated and competitive European payments market.

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I. INTRODUCTION

In its conclusions³ on 24th March 2006, the European Council called for the adoption of a Single Payment Area in the EU. More recently, the ECOFIN Council at its meeting on 5th May 2006 stressed the importance of the Single Euro Payment Area (SEPA) and invited the FSC by autumn 2006, together with the Commission, to examine how to best make progress in this field by 2010.

The current note, prepared with the technical assistance of the Commission services, aims to provide the FSC with the background for responding to that mandate by examining the state of play on SEPA and to outline how the Member States can contribute to progress. The note is structured as follows:

- Section II gives an introduction to the basic elements of SEPA;
- Section III outlines the state of play on the constitutive elements of SEPA: the work of the EPC, the Proposal for a Directive on Payments Services (PSD) and the national migration plans;
- Section IV describes, non-exhaustively, some of the main concerns raised and indicates, where possible, to which extent these concerns are met or where further work needs to be done;
- Section V deals with the issue of the timing of SEPA, and
- Section VI set out some suggestions as to how Member States could contribute to SEPA progress.

II. BASICS OF SEPA

1. A short history

SEPA find its origins in the introduction of the Euro. Since 1999, the participating countries shared a currency and had an efficient infrastructure to make large-value payments (e.g. via TARGET or EURO1). For non-cash, retail (low-value) payments the situation was different. When the cash changeover to the Euro took place in 2002 the participating countries shared notes and coins but not the infrastructures necessary to transfer the Euro freely electronically around the area in which it was the currency.

³ Document 7775/06, Brussels, 24 March 2006

Each national retail market remained isolated from the other national payments markets and the level of efficiency and service varied greatly from Member State to Member State. Cross-border retail payments in Euro also remained slow and inefficient. A transfer within the national system can usually be done the same day, or at least during the following day, while getting a payment across borders can take up to a week. This is mainly because the rules, procedures and standards for payments are different in each country. So while goods and cash can travel freely across Europe, electronic payments to pay for the goods are still held by national borders.

With the aim of at least reducing the bank charges for small amount cross-border payments in euro and to bring these charges in line with those applying at national level, Regulation 2560/2001 on cross-border payments in euro was adopted in 2001. This also put pressure on banks to develop solutions for cross border transactions.

In 2002 the banking industry then decided to take the lead towards efficient payment systems, not least because of the perceived pressure that Regulation 2560/2001 put on banks and to avoid any further regulation from the side of the Community legislator. The vision for the SEPA was formulated in 2002 and the European Payments Council (EPC) was created, when some 42 banks, the three European Credit Sector Associations (ECSAs) and the Euro Banking Association (EBA) came together and made the following declaration which was subsequently incorporated into the EPC Charter:

"We, the European banks and European Credit Sector Associations:

- share the common vision that Euroland payments are domestic payments,*
- join forces to implement this vision for the benefit of European customers, industry and banks and accordingly,*
- launch our Single (Euro) Payments Area."*

2. What is SEPA?

At its simplest SEPA can be visualised as an electronic "transportation system" on which money can travel. The rules and frameworks elaborated by the EPC determine "the vehicles" (i.e. payment instruments, such as credit transfers and direct debits) and, to certain extent, how computers in banks and other payment services providers (PSPs) communicate with each other (i.e. technical standards), and thus create the "electronic roads".

The individual components are set out below in Section III entitled "SEPA components". The Payments Services Directive, see Section III Chapter 5 below, " sets out the basic provisions the electronic payments traffic must respect and removes the legal barriers for payments to travel on these "roads."

Currently payments can only "travel" freely on national "transportation systems"; to "travel" to another national "transportation system" is often slower and more costly. Banks and other PSPs using the SEPA "transportation system" will, however, have freedom of choice of the most efficient road available to them. The banks' customers will be able to choose a bank anywhere in the euro area to make its electronic cashless payments. Moreover, banks will be able to select the infrastructure that best suits their needs.

Essentially SEPA is not about making cross-border payments, but about making borders for payments obsolete by creating an integrated EU-wide payments market in euro⁴.

The users (consumers, merchants, corporate users and public administrations) will in many ways experience the concrete benefits of SEPA. In principle after the full introduction of SEPA a customer will no longer be bound to use a domestic bank in his or her country of residence: a Dutch consumer could use a Portuguese bank, pay in the shops with the debit card from the Portuguese bank and pay telephone and electricity bills via direct debit, as if the bank had been situated in the Netherlands.

⁴ Initially. SEPA is not, however, limited to the euro-area. SEPA requires only that the interbank-leg (clearing and settlement) is euro-denominated, the payment products can in principle be used also for other currencies and in non-euro Member States. Banks, see Section I.4 below.

The same way a company doing business in several countries could centralise all payment functions in one place, instead of having to group payments country by country. Thus the consumer or the company using payment services would have a choice between any payment service providers offering SEPA products regardless of where the payment service provider is located.

3. The aim of SEPA

The main goal of SEPA is to foster the integration of the payments market in particular in the Euro area and to stimulate efficiency and innovation in this field, by removal of the national barriers to payments that hamper competition and interoperability at the euro area. SEPA will help to make payment services comparable and transparent to users by introducing new harmonised payment instruments and payment services, which can be offered by all banks in the euro area and thus make increased competition possible.

The potential savings are enormous⁵:

<u>The Business Case for SEPA</u>	
	<u>Benefits in billion €</u>
-Payment accounts price convergence (varies by factor 1:8)	13-29 ⁶
-Product standardisation & infrastructure consolidation	10.0
-Increased use of electronic payments instead of cash/cheques	<u>5.3</u>
Estimated SEPA savings:	28.3 minimum p.a.
<u>Additional savings if SEPA used as a launch pad for e-invoicing</u>	<u>>100 billion euro p.a.</u>
Banks SEPA implementation cost	0.5-5 billion euro ⁷

⁵ See previous document FSC 4165/06 and the Commission impact assessment set out in document SEC (2005) 1535, 1.12.2005

⁶ CapGemini WRBR 2005

⁷ BGC, Global Payments 2006

The greatest beneficiaries would be citizens, consumers or businesses, making cross-border payments and users making internal national payments in Member States where these are still very costly. Citizens making internal payments in Member States where the current national systems are already fast and cost-effective would notice less, if any difference. But opening up national markets to competition from other Member States, potentially can bring savings to customers estimated between EUR 13 and 29 billion. This derives from the fact that price levels diverge between Member States in order of 1:8, which obviously leaves room for improvement through integrating the market.⁸ See also Section III.6 “Concrete effects of SEPA” below.

The costs of introducing SEPA are not negligible given that SEPA in ambition can be compared to, the introduction of Euro notes and coins. SEPA will involve substantial investments for banks so depending on the way the investments can be planned and phased, the cost are estimated in a range of EUR 0.5 billion to EUR 5 billion⁹, which are one off investments and should of course be seen against the much greater gains and savings that can be made every year.

4. The scope of SEPA

As the name implies, SEPA primarily focuses on payments in euro within the Community, whether or not the Member State(s) where the payment takes place has introduced the Euro or not. The SEPA instruments and services can be used within a Member State as well as for cross border payments, since there should be no difference. SEPA is not, however, limited to the euro-area. SEPA requires only that the interbank-leg (clearing and settlement) is euro-denominated, the payment products can in principle be used also for other currencies and in non-euro Member States. Banks, and payment institutions as defined in the forthcoming Payment Services Directive, would be able to develop SEPA-products irrespective whether they are located in the euro-area or not.

The current national products and instruments will continue to function in parallel with SEPA for a while. The timetable foreseen by the EPC at the launch of SEPA in 2002 was that the first SEPA products should be available to consumers and businesses from the beginning of 2008.

⁸ CapGemini World Payment Report 2005, World Retail Banking report 2005

⁹ Boston Consulting Group, Global Payments 2006

Then for a few years SEPA and national products and instruments could co-exist, while payments (both national and cross-border) increasingly would migrate to SEPA standards and products so that by end 2010, a critical mass of transactions should have migrated to SEPA. For more about the timing see Section V below entitled "Timing". No legislative provisions or EPC agreed standards would, however, oblige national systems and products to cease, but if SEPA can deliver on its promises, SEPA products would simply be better, and it would no longer be worth the cost and effort at keeping national products and pure national infrastructures to process them in parallel.

However, if SEPA products are not better in terms of price and quality than the products currently delivered by the national systems and service providers, SEPA could degenerate into an additional system for cross border payments only, the so-called "mini-SEPA" scenario. This could be considered, at least in part, as a failure: the efficiency and competitive gains of the internal market will not have advanced, while significant investment will have been incurred for providing only a cross-border payments for which (albeit inadequate) solutions are to some extent already in place under Regulation 2560/2001, see below, Section IV.2 "SEPA is over ambitious".

5. Responsibility for SEPA

SEPA is and should remain a market-driven project. The EPC has since 2002 made enormous strides towards the establishment of SEPA and this unique endeavour has made SEPA move from a dream to reality and has created a solid foundation for progress.

The banking industry is represented by the European Payments Council (EPC), the decision-making and coordination body, with the declared purpose to support and promote the creation of SEPA. The EPC defines the necessary rules, procedures and standards (laid down in schemes and frameworks) that banks need to agree on to successfully execute payments among each other. Banks will on the basis of these schemes and frameworks develop concrete products which banks can in competition offer to their clients.

The industry cannot, however, operate in a vacuum. SEPA is a major European objective which in ambition, size and complexity can be compared to the changeover to the Euro. Public authority support for SEPA has not been lacking either.

The Commission and the ECB most recently on 4 May 2006 announced a shared common vision for the Single Euro Payments Area (SEPA) and the process leading to its realisation. The European Council has also called for the adoption of a Single Payment Area in the EU, and the ECOFIN Council at its meeting on 5th May 2006 stressed the importance of SEPA. The support required from Member States is set out below in Section VI "Contribution by Member States".

III. SEPA COMPONENTS

The EPC has produced from scratch a scheme for credit transfer and a scheme for direct debit. For card payments EPC has developed a framework to which card schemes will have to comply. The Cards framework provides the principles for the realisation of a competitive market on the European level. For the infrastructures processing payments, the EPC has likewise developed a framework, which gives guidance to service providers that want to offer payment services in the new SEPA environment.¹⁰

1. The scheme rulebooks for credit transfer and direct debit

The aim of SEPA here is for all euro area credit transfer transactions and direct debits (pre-authorized debits on the payer's bank account initiated by the payee, e.g. a utility or telephone company), within or crossing national borders, to be processed in accordance with the SEPA Credit Transfer scheme or SEPA Direct Debit scheme respectively.

Payments are a network industry and competitors need to agree on the standards and rules for exchanging payments. Effective competition therefore requires first effective cooperation. To establish cooperation and to create an effective competitive market, the EPC structured its work on credit transfer and direct debit in three layers.

¹⁰ In addition the EPC is working on a complementary initiative: the Single Euro Cash Area "SECA" The objective of SECA is to create a common infrastructure for cash (banknotes and coins) handling and transporting in all euro countries.

1. **SEPA products and services** will be offered by banks in competition. Banks will on the basis of individual commercial considerations develop concrete product offerings in terms of price and service levels. These service levels will be based on what the banks have agreed on in the next two layers:
2. **The scheme layer** defines the interbank rules on which banks co-operate. Not only does the scheme provide technical standards (e.g. message formats) that ensure technical interoperability, rules, the scheme also defines the rules to which all participants have to stick (e.g. execution time, rejection handling and liability arrangement). For defining, managing and developing schemes competitors need to cooperate.
3. **The processing infrastructure** is partly competitive and partly cooperative space. Common principles need to be agreed to ensure interoperability and guarantee that all banks can be reached. On the basis of these principles, however, processing infrastructures can compete with each other and banks have the choice to choose the infrastructure that best fits their requirements.

The credit transfers and direct debits rulebooks were approved by the EPC Plenary in spring 2006. As a result of comments by the Commission and the ECB, the EPC is working on improvements, for example, the governance arrangements, for mandate handling in the Direct Debit Scheme etc.

2. The SEPA cards framework

Given the diversity in the cards business, the widely differing ways in which national card market are organised and the presence of the major International Card Schemes, e.g. VISA and MasterCard, the EPC decided not to draw up a new common card scheme and Rulebook. Instead the EPC decided to develop a more general policy document called the “SEPA Cards Framework” which states general principles for a competitive cards market in Europe. On the basis of the Cards Framework issuers and acquirers, card schemes and operators must adapt their current operations.

The SEPA framework for cards should enable European customers to use debit and credit cards for payments and ATM cash withdrawals in euro throughout the EU and EEA with the same ease and convenience as they do in their home country.

Currently not all cards allow a customer to use his card abroad, because merchants often do not accept cards issued under a foreign domestic scheme due to technical or commercial reasons. Moreover, some merchants are even unwilling to accept cards issued under an international card scheme, particularly because of the high fees.

The policy document represents a valuable achievement given the multitude of existing card schemes. However, some major issues still remain unsolved, (see also Section IV “Concerns expressed” below). Both the Commission and the ECB have asked the EPC to flesh out further details, e.g. the development of open technical standards in four domains (card-to-terminal, terminal-to-acquirer, acquirer-to-issuer, and type approval domain) compatible with the time table of the SEPA project.

3. Other operational issues

3.1 Management

The decision making body of the European Payments Council is the Plenary which has established several working groups to address various aspects of SEPA: one for each of the three non-cash instruments (i.e. credit transfers, Direct Debit and Cards) as well as one dealing with cash. In addition a working group has been set up to deal with standards (operational, infrastructure and technical) and another to give legal support.

A committee, called the Roll Out Committee, has been established to prepare and support the successful and consistent implementation of the SEPA Credit Transfer and Direct Debit schemes until a permanent Scheme Management Entity is in place. The Scheme Management Entity is currently being developed and is scheduled to be in place, the beginning of 2007. Currently, the idea is that the EPC will take care of the change management of the schemes (for example the inclusion of new features), while the Scheme Management Entity will take care of possible dispute resolutions regarding the use of the schemes.

3.2 Standards

The availability and adoption of technical standards for instruments and infrastructures is a key factor for the success of SEPA. Only by removal of the technical barriers that prevent banks and system operators from offering their services anywhere in the euro area, can competition increase and lead to efficiency gains and more innovation. However, technical standards should not become an obstacle to competition and development; the standards and their governance must be flexible enough to cater for the development and provision of new basic and additional services. The EPC has made substantial progress on this, but work remains to be done.

4. The Payment Services Directive

On 1 December 2005 the Commission presented its proposal for a Directive of the European Parliament and of the Council on Payment Services in the internal market. The proposed Directive establishes the necessary legal framework for SEPA but will also apply to existing national payment products.

The three main building blocks of the proposal are:

- *Right to provide payment services to the public*

The harmonisation of market access requirements for non-bank payment service providers is designed to create a level-playing field, instil more competition in national markets and reflect market developments in recent years, triggering market entry of a new generation of providers, e.g. mobile telephone operators.

- *Transparency and information requirements*

The Directive will introduce a clear and succinct set of harmonised information requirements, which all Payment Service Providers (e.g. banks or money remitters) should fulfil whether or not they are offering SEPA products or existing national electronic payment products. This will improve transparency for customers and fully harmonise 25 sets of different national rules.

- *Rights and obligations of users and providers of payment services*

Clarity and certainty on core rights and obligations of users and providers of payment services are essential for the development of efficient electronic payment systems, for the trust of users and efficiency of business. They also provide the necessary legal framework for SEPA to operate, e.g. it would be difficult to establish a common cross-border, direct debit scheme without harmonising the existing, differing national legal requirements.

The Proposal for the Payments Services Directive is currently being examined by the Council, in the Working Party on Financial Services, and by the European Parliament. Building on the substantial progress made under the Austrian Presidency, the Finnish Presidency is working to secure an agreement with the European Parliament in first reading before the end of the year, see also Section V "Timing" below.

5. National planning (migration plans)

In 2008 banks should offer SEPA payment products to their clients. Then users will start adopting these instruments over time. This migration will take place from 2008 onwards and the EPC hopes that by end 2010 a critical mass of payments will have migrated to the SEPA instruments. For this to succeed all banks and other payment service providers must adhere to the SEPA schemes.

In order to facilitate migration on the national level, the process must be monitored to ascertain whether it is happening and to identify possible problems and remedies. The banks have initiated the setting up of national migration platforms. Structures have been put in place already in a number of countries. But others are lacking.

A number of euro area countries already have a formal implementation and migration plan in place (BE, ES, IE, NL, FI). Others are currently in the process of finalising it (AT, DE, FR, GR, IT, PT). The level of detail of the plans in the different countries seems to vary considerably.

While some countries appear to have a detailed project implementation plan on which relevant stakeholders are consulted, other seem to have developed a more general plan which is shared mainly, if not exclusively, with banks.

In some countries information on the SEPA project is provided to all relevant stakeholders, but in most countries not all relevant stakeholders are participating in the SEPA preparation. In particular, public administrations are often not yet actively involved.

Representatives of public authorities are participating in the preparations in Belgium, France and Italy. In the other countries public authorities are being kept informed about the SEPA project by the national central bank or by the private sector project managers. No public authority has so far declared its intention to become an early user of the SEPA payment instruments.

The EPC plans to set up programme management offices in each Euro area country in autumn (subject to approval by the EPC Plenary). These programme management offices will be responsible for the implementation of and migration to SEPA.

6. Concrete effects of SEPA

The concrete possibilities open to users by SEPA will be many and varied. It will go beyond the scope of this paper to set them all out.¹¹The following represent just some examples:

- Consumers will benefit greatly from the wider choice of payment service provider and increasing competition between them. They will also immediately benefit from the fact that sending money across borders will be simplified. Those consumers who choose, should be able to rely on one account, whether in their country of residency or not, and one payment card which can be used throughout SEPA. This greater choice should bring down present charges in high cost countries.

¹¹ The document by the European Payments Council entitled “Making SEPA a Reality – Implementing the Single Euro Payments Area”, distributed to FSC members, sets out in its Chapter 3, entitled "the SEPA end-user experience", the effects on various groups of users, consumers, merchants, corporates and public administrations.

- Merchants should benefit from the fact that card acceptance will be extended, because most cards will become SEPA compliant. Moreover, the choice between acquiring banks will be larger. In addition, all SEPA compliant cards must be chip-based (i.e. the magnetic stripe will not be SEPA compliant) and will be authenticated using PIN rather than signature thus significantly reducing fraud. Terminal costs are expected to decline as a common, lower cost SEPA terminal application is developed and implemented.
- Corporate users and merchants will be able to organise their payments activities much more efficiently using a single treasury centre for their cash management, centralising all euro area payments and collecting through a uniform cross border direct debit procedure.
- Public administrations as large users of payment services will also benefit from more cost efficient national payment systems as above and the possibilities for promoting e-government.

IV. CONCERNS EXPRESSED

A number of concerns relating to SEPA have been expressed by Member States, the Commission in its consultative paper on SEPA, and by the ECB in its Fourth Progress Report on SEPA. The current paper sets out a non-exhaustive list of the frequently raised concerns and indicates where current work on SEPA could respond to these concerns, as well as where further improvement seems needed.

Specific concerns relating to the Payments Directive, such as execution time, fall outside the scope of this paper and will be dealt with in the negotiations leading to the adoption of the Directive.

1. Risk that SEPA could lead to a decrease in services and/or to higher prices

All parties agree that SEPA is a market-driven process: the adoption of SEPA Payment Services by consumers, enterprises and Member States' public authorities will only happen if SEPA products have performance characteristics *at least as good as, and preferably better* than, existing national payment products (See also below SECTION VI "The contribution of Member States"). Only in this way can the full benefits of SEPA be realised.

The concern has, however, been expressed that SEPA could lead to a decrease in services and/or to higher prices in Member States where efficiency is already high and cost low.

There are three dimensions to this concern:

- The migration to new SEPA products may not be entirely voluntary, if the payment service providers simply cease to provide the current national payment products and replace them with SEPA-products. In the absence of information on future service levels, consumers and enterprises may not be able to react before it is too late.
- If the SEPA basic products do not meet the service level of existing national products, the payment service providers will cover the difference by providing additional services. The problem is that additional services very seldom come without additional price.
- Furthermore, the SEPA-technical standards and interbank payment systems may not cater for all types of additional services demanded by national markets (e.g. relating to e-invoicing).

These issues are linked to SEPA governance. The governance structure should have wide representation and appropriate consultation arrangements, so that the products defined would cater for the general demand of users (as well as adoption of new product and/or service innovations) as basic SEPA-payment products. Effective governance structures including other parties than banks are currently lacking.

The efficient governance of technical standards is equally important to the governance of payment products. Since the underlying idea of EPC work is to separate basic products and additional services, the standards must not be defined on the basis of basic products but should be able to cater for the current and new additional services as well (e.g. e-invoicing, reconciliation codes, VAT-information) without the risk of them breaking the STP-chain (straight-through-processing). If the standards are inappropriate and inflexible, the infrastructures are not able to support additional services, thus hampering innovation and competition.

There are several arguments to alleviate these concerns:

- It is too early to judge the future service level of SEPA products, because there are no concrete products available yet. Because SEPA will be the market for pan-European competition, it is in the banks' own interest to offer products and services which are at least as good as the current national products. So this concern seems to be inspired to some extent by the EPC schemes, which provide only a core and basic service level to ensure interoperability.
- Banks have to develop SEPA products on the basis of the EPC schemes and will be under increasing competitive pressure make sure that their service level does not deteriorate and that prices do not rise excessively. The EPC stresses that the provision of additional optional service on top of what the core scheme provides for, will guarantee the maintenance of existing service levels. Indeed, once common standards are available, this will provide the opportunity more performing banks to compete outside their country.

Nevertheless, public authorities should closely follow developments and be able to intervene swiftly, if necessary. Firstly, competition authorities in all Member States should closely scrutinize the implementation of SEPA schemes by banks in order to make sure that banks do not abuse SEPA as an opportunity to cooperate to lead to deteriorating service levels, or excessive price increases. Particular attention will be paid to cases of forced migration.

These and related issues are raised in the consultative paper of the Commission, dated 13 February, where a number of questions are posed to help the Commission decide what, if any, further actions may be needed to help ensure the success of SEPA¹². The Commission could be invited to continue its work on the next steps regarding the issues raised in its consultative paper without delay (particularly in order to address the lack of ambition EPC schemes/standards and effective governance).

As a last resort there is always the possibility of regulatory intervention to guarantee service levels be improved.¹³

2. SEPA is overambitious

Concern has been expressed that SEPA is overambitious and that it would suffice to keep it as a separate scheme for cross border payments only, leaving national systems intact (the “mini-SEPA” option). This option has to be rejected for several reasons.

It is true that SEPA is an ambitious project. But considering the divergence of prices between Member States and the great potential savings in the payment infrastructure and for users, it is unacceptable that the payments business remains unaffected by the logic of the internal market and remain protected and fragmented through national standards.

There is no business case for only developing a cross border solution only, as the banks argued in the past. SEPA is built on the premise that combining cross border and domestic payments has clear advantages because payments are a scale business with economies of scale. Having separate national systems in parallel to a cross-border only system is more expensive than running an integrated system with full economies of scale.

¹² http://ec.europa.eu/internal_market/payments/docs/sepa/sepa-2006_02_13.pdf

¹³ In the joint Commission/ECB press release of 4 May 2006 it is stated that: " The Commission and the ECB support to the greatest possible extent continued self-regulation by the industry, but given the importance and the size of the social and economic benefits of SEPA, the Commission expressly reserves the right to introduce or propose necessary legislation to achieve it".

Furthermore, instead of monopoly processing and clearing systems, as is currently often the case at national level, in SEPA it will be possible to have competing payment infrastructures at EU level that can deal with all payments (both national and EU) operating on a more efficient scale and competing with each other. SEPA will thus create effective competition at an EU level. This means increasing choice for users, rising service levels, lower prices and stimulating innovation (e.g. additional services such as e-invoicing).

Concern has also been expressed that the migration to SEPA will entail unnecessary costs for banks and customers who are content with the present systems.

This concern implies that the choice is between only low performance/ low cost products and high performance/high cost products. This is not necessarily true: efficient, high-quality systems tend to have low prices for end users. As payments is a scale business and as a result of the increased competition from outside the Member State and from new players (payment institutions), SEPA should improve the general efficiency of the payments infrastructure in Europe thereby allowing users to benefit from high performance/low cost products already available elsewhere today. For an estimate of the costs see Section II.3 The aim of SEPA above.

3. Transparency of pricing

Some concern has been expressed that the move towards more transparent pricing might upset consumers who have been used to regard the hidden payment costs as non-existent. But transparent pricing is essential for SEPA. First of all, the immediate effect of increasing competition in the payment market will be declining prices on average. This will particularly be the case, because of the large divergence of prices that customers face nowadays and the higher fees that users are supporting in some markets. (Ratio of 1:8 of price levels between Member States.)

Secondly, it is essential for any effectively functioning market that services and products are transparently priced. If not, the price mechanism cannot be used as an instrument to ensure the efficient allocation of resources.

Unfortunately, this is not the case for payments today where the use of expensive products such as cash and cheques is often subsidised by efficient electronic products. The Payment Services Directive aims at removing intransparent pricing methods by reducing float income and banning value dating. This may drive banks to price payment products to reflect true cost.

Thirdly, if prices for some products are below cost, this hampers the functioning of the internal market as it will be an impediment to market entry and the attainment of broader efficiency of the payment system in the Member State concerned.

However, in a number of Member States, the true pricing of payment services is not visible to end users. Even if execution times are short and value dating is limited, there may be cross-subsidisation from revenues out of other activities to keep the prices of payment services low. Therefore, users in these Member States perceive of payments as a free service. Introducing transparent pricing based on the true cost of the instrument could well generate wide public resistance which may be blamed on “Europe” or “Brussels” and recognition of the fact that the introduction of cost-based pricing will be beneficial overall, could be lost.

Consequently, a coordinated information campaign will be needed to convince the public of the need for transparent prices stressing that there is no such thing as a free lunch. One way or another, customers pay the price, often through annual or intransparent package fees. And this price will go down over time as improved efficiency reduces the cost of the payment system as a whole.

4. Issues with regard to the SEPA Cards Framework

The SEPA Cards Framework raises a number of concerns, because of the possible effect of reducing competition, both in the offering of card products to users and in the processing of cards.

With regard to card products, there are major concerns with the open approach chosen, because it entails a risk that fragmented national markets will integrate but only at the cost of moving to more expensive international cards.¹⁴ As concrete examples of the concentration risk, there are indications that smaller banking communities (e.g. Belgium, Ireland) will abandon efficient national debit card schemes and could move to more expensive, international card schemes (VISA, MasterCard) to become SEPA compliant. There were complaints that the move from the national brand to Maestro in the UK led to much higher merchant service charges.

The reasons underpinning this choice are threefold.

- Firstly, it would be extremely difficult and costly for national schemes to create and maintain an EU-wide acquiring network together with necessary clearing and settlement infrastructures. In any event they would depend upon the major international card schemes for payments outside the EU. In addition, the business risk of significant investment could be seen as excessive.
- Secondly, the timetable for SEPA compliance is very tight. According to the original time plan SEPA cards should be available from 2008, which leaves national schemes with little time and therefore limited choice.
- Thirdly, it is basically the banks that decide on the future of national domestic schemes, because in most cases banks own them. Banks have an incentive to move to the international card schemes because the revenues from card transactions under the international card schemes are higher because of the use of higher multilateral interchange fees. (see below)

¹⁴ The Commission's First Interim Report on the Sectoral Inquiry on cards concludes that national debit card schemes offer a better value proposition than the international card schemes: their service levels are comparable, but their prices both for merchants and cardholders are lower.
http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_1.pdf

With regard to processing of card payments the same concern of reducing competition in SEPA exist. Two conditions for effective competition in the European market for card processing are not addressed in the Cards Framework:

- There are several standards to be defined in the processing chain of card payments. These standards should not be proprietary, because that may eliminate competition.
- There has been little discussion with regard to the international card schemes on the principle of separation between schemes and infrastructure. There is little prospect of enforcing an effective separation through a bank-led self-regulatory process.

A final problem for effective competition in the cards market is the practice of intransparent pricing. Particularly, the use of a multilateral interchange fee obscures costs to cardholders. The multilateral interchange fee (MIF) is the fee the cardholder bank (the issuing bank) charges to the bank of the merchant (the acquiring bank), when it settles the payment made by the cardholder. The MIF constitutes a large part of the merchant service charge (over 50%) and is therefore ultimately paid for by all consumers in higher overall prices. The issuing and acquiring banks can agree bilaterally on these fees, but if they fail to do so, then the fall back fee is the multilateral interchange fee (MIF), which is typically set by the national banking community. In practice, bilateral agreements are rare and the MIF usually applies.

The Commission found that the level of MIF in a majority of member states is high and basically adds to the profitability of the issuing bank.¹⁵ High levels of MIF may partly be due to the fact that competition between schemes does not drive down the MIF, but rather the contrary. This perverse effect emerges, because schemes compete for banks to join them and may offer a high MIF to attract them. The MIF, again, constitutes an important source of revenue for issuing banks.

¹⁵ See DG Competition Sectoral Inquiry first interim report Cards

MIFs have been the subject of many complaints and investigations by (national) competition authorities. Earlier this year, the Commission launched a major enquiry into the functioning of the card market and more recently has sent a statement of objections regarding interchange fees to one of the major international schemes. The Commission is addressing these deficiencies, but that will take some time.¹⁶ The banking community argues that this creates uncertainty in the market and may have a delaying effect on realising SEPA for cards.

5. Security of payment cards and accepting devices

User confidence is a key factor of success for the development of SEPA-payment services. The increased interoperability of the SEPA-products and, in particular the wide geographic reach of the SEPA instruments, makes them vulnerable to fraud. Any known vulnerability in a payment instrument accepted all over the EU could be exploited quickly, potentially resulting in both financial loss and loss of user confidence. For cards, the use of chip and PIN-code and standards like EMV increases the security of card payment systems, but it does not solve all problems. For instance, card and device manufacturers may be tempted to manufacture inadequate security features in order to save costs.

Therefore, it could be considered defining harmonised high-level minimum security requirements for cards and accepting devices, together with appropriate evaluation and certification structure. This would also potentially reduce the costs and promote competition as card and device manufacturers would no longer need to differentiate and certify their products according to national rules.

¹⁶ The Commission is consulting the market about possible ways to address the issues identified and considers to address the problems through competition law enforcement, but does not rule out regulatory action either.

V. TIMING

The EPC has defined three phases in its project to realise the Single Euro Payment Area: a design, an implementation and a migration phase. At present the design phase is approaching its end. The schemes and frameworks and basic standards have been adopted by the EPC Plenary meeting of 8 March 2006.

After that the banks and related institutions are expected to implement these schemes, frameworks and standards and to develop SEPA products on that basis. This phase was originally scheduled to end by 1 January 2008 when SEPA products should first become available to customers. Then the migration phase is planned to start in which adoption of SEPA products starts. This should lead to an irreversible uptake of the new SEPA products reaching critical mass within 3 years by the end of 2010.

This plan was build on the assumption that the Payment Services Directive would be implemented in the Member States by 1 January 2008.

Both the Austrian and Finnish Presidencies, and the European Parliament have given high priority to the Proposal for the Payment Services Directive. Negotiations on the Proposal are progressing and the Finnish Presidency hopes to be able to reach an agreement with the European Parliament in first reading before the end of 2006. This implies that publication will take place in the spring or summer of 2007¹⁷. Given that Member States need 18 months to implement a Directive of this complexity¹⁸, this means that the Directive cannot be implemented in Member States until late in 2008.

This goes beyond the deadline of 1 January 2008 for the launch of the first SEPA products. What exactly this would entail for the launch of SEPA is not completely clear. Some elements of SEPA could perhaps be implemented before the transposition of the Directive into national law. This issue could be examined further by the EPC, in co-operation with national SEPA coordination structures, to provide greater clarity on the matter.

¹⁷ This delay is caused by the complicated process of double-finalisation of the text between the Council and the Parliament, and can not be significantly shortened.

¹⁸ The Commission Proposal to implement after 12 months is likely to be rejected by Member States.

VI. CONTRIBUTION BY MEMBER STATES

SEPA is essentially and should remain a market-driven project. The substantial efforts made by the EPC have been set out above and should be recognised by all, but industry cannot work in a vacuum. Some issues remain open, and while public authorities cannot solve all the open issues they must, however, contribute to progress, as was recognised by the ECOFIN Council in May.

In light of what is set out above, it seems Member States can contribute in three ways:

- Commit to *early adoption of the Payment Services Directive*. The legal framework for SEPA is essential, see Chapter III. 5 above;
- Commit to the *early use of SEPA products*. Early commitment from public authorities will help kick start the use of SEPA products, and thus mitigate the investment risk for the Payment Service Providers. The commitment would make Payment Service Providers more willing to invest in SEPA and may thus in itself contribute to a lowering of prices and improvement in quality. The exact nature and price of the SEPA products are not yet known, so all that can be signalled at this stage is a political commitment to use SEPA products for the huge mass of payments carried out by public authorities in the Member States. However, this is evidently *on the absolute condition that these products are better or at least equivalent to existing products* in terms of price and quality. Degradation in terms of quality or price is unacceptable.
- *Monitor national migration plans*. Member States should play an active role both as a user and as public authority in the national migration platform, which is in charge of organising the implementation and migration.

The FSC could be invited to monitor progress on national implementation. Member States could report back regularly to the FSC on implementation and migration to SEPA, signal any risks and barriers identified and consider ways to mitigate or remove them.

Many of the concerns referred to in this note were already flagged in the consultative paper on SEPA Incentives by the Commission, and the Commission could be invited to continue its work on the next steps regarding the issues raised in this paper.