European Payments Council

EPC Newsletter

FOCUS: SEPA MIGRATION

So what´s in a Name? Explaining payment schemes, instruments and systems

Clarity on payment terms is critical in the debate over the approach to setting end dates for migration to SEPA through EU Regulation

25.10.10 BY GERARD HARTSINK

In the two previous issues of this newsletter, the EPC highlighted the implications of possible forthcoming EU Regulation related to SEPA. The EPC's analysis is based on two papers published by the European Commission (EC) earlier this year: these EC papers outline the main proposed provisions of regulation establishing end dates for the compliance of euro payment schemes with "essential requirements". The EC recently announced that a **public hearing will be held on 17 November 2010 to ensure that all market participants are consulted on the most appropriate approach to regulatory intervention related to SEPA**. The EC further indicated that it will introduce a formal proposal for such regulation once the arguments brought forth at this public hearing have been evaluated. The EPC welcomes the opportunity to further consider the subject in dialogue with all stakeholders and the EC.

Throughout the past decade, it has been understood by all - including the EC - that the SEPA process aims to replace national euro credit transfer and direct debit schemes with the SEPA Credit Transfer (SCT) and SEPA Direct Debit (SDD) Schemes developed by the EPC . The forthcoming regulatory intervention as conceptualised by the EC in the two related EC papers of March and June 2010, however, would deliver a different outcome. In these papers, the EC introduced a radically different SEPA vision based on the concept of multiple "competing" and "interoperable" SEPA payment schemes.

The EPC reiterates that an optimally efficient payment environment would require that all payment service providers, of all payment service users, adhere to exactly the same scheme rules and standards (which does not prevent competition on SEPA payment products and services). The result is that a payment is executed by parties which adhere to the rules and standards of the same payment scheme. Interoperability between multiple competing euro credit transfer and direct debit schemes would require onerous agreement at an extremely high level of detail to allow fully automated processing of payments across multiple payment schemes. It would also do little to overcome the fragmentation of the euro payments market.

To highlight the purpose of migrating euro credit transfers and euro direct debits to a single set of SEPA payment schemes, EPC Chair Gerard Hartsink recalls the principle objectives of the SEPA harmonisation exercise as defined by the political authorities. In addition, he clarifies the meaning and scope of the terms "payment *instrument*", "payment *scheme*", "payment *system*", and "payment *services and products*". It is hoped that the clarification of these terms will aid in the process of defining a Regulation which ensures swift migration to SEPA. It would be highly regrettable, to say the least, if SEPA - which is the most ambitious EU harmonisation project in the area of payments since the euro

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introduction - would fail because of confusion over semantics.

Don't blame the customer: EU integration is not a grassroots movement and SEPA is no exception to this rule

The findings of two surveys which identify the latest trends in European payments (see links to related articles below) and recent EC figures on the SEPA migration rate among public administrations (see link below) confirm: without clear deadlines for migration to the SEPA payment schemes the demand side shows little motivation to make the transition. While there are notable exceptions, both in the private and public sectors (see the article "Preparation for SEPA by Public Administrations in France"; a link is included below), it is recognised that SEPA - like most other EU integration initiatives - is not a demand-driven process.

As stated in the very first edition of the EPC Newsletter published in January 2009 (see the article "Cheer up: SEPA is On Track and Open for Business"; a link is included below), the SEPA vision will not be realised through the existence of high-quality SEPA payment schemes alone. The EU monetary union did not materialise by simply throwing euro notes and coins at people in the hope that they would enthusiastically abandon beloved national currencies. European integration is rarely carried forward on a wave of popular support. SEPA is no exception to this rule. The vast majority of bank customers in the European Union have never asked for SEPA payment schemes with a view to replacing national ones.

SEPA was not started as a demand-driven process, but as a policy-maker-driven EU integration initiative. The political SEPA vision aims to generate macro-economic benefits, strengthen the euro currency, drive forward the integration of the internal market and accelerate technological innovation in payments and beyond. In other words, SEPA is supposed to promote the public interest of European citizens at large. The current rate of SEPA market uptake [1] therefore, is perfectly in line with the progress of any other major EU integration initiative promoting a good that is not assumed to produce immediate benefits, requires initial investment to be realised and *lacks clear regulatory direction*. The European Commission itself recognises that full migration to SEPA would take some thirty years if projected based on market uptake to date. Consequently, the majority of stakeholders recognise that deadlines for SEPA migration must be set through EU legislation[2].

A friendly reminder: the primary SEPA objective is the integration of the euro payments market

In the second edition of the EPC Newsletter published in April 2009 (see the article "On Bananas and the Integration of Euro Payments"; a link is included below), we quoted Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank (ECB), who argued the case for the integration of the European financial market. According to the ECB's definition, **financial markets are considered integrated if all agents face the same set of *rules*, are treated equally and have equal access to financial *products***.

In the ECB's view, financial integration "not only contributes to the smooth and effective transmission of the single monetary policy throughout the euro area, but also to the **smooth operation of the underlying payment *systems***. Financial integration also **increases the depth and liquidity of financial markets**, and consequently **enhances the resilience of the European financial system**. It also **offers greater scope for geographical risk diversification, promoting consumption and income risk sharing**. Integrated financial markets **help to realise the full economic potential of the European Union**, as recalled in the Lisbon Strategy. Financial integration **contrib contributes to the development of the financial system by increasing *competition* and expanding markets**, which results in **lower intermediation costs and a more efficient allocation of capital**. These effects, in turn, **raise raise the potential for long-term non-inflationary economic growth**"[3].

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"The integration of the European retail payments[4] market has yet to be achieved," Ms Tumpel-Gugerell concluded at the time. "**The creation of SEPA will enable customers to make cashless payments throughout the euro area with a *single set of* payment *instruments* from a single bank account, regardless of their location**. **The Eurosystem considers SEPA as an extremely important project for the European financial integration**."

Remembering the SEPA vision shared for the past decade

Earlier this year, the European Commission indicated that it might introduce a formal proposal for a Regulation establishing end dates for euro credit transfer schemes and euro direct debit schemes to comply with "essential requirements". The EPC welcomes the European Commission's willingness to legislate on end dates for migration to SEPA. Throughout the past decade, it has been understood by all - including the EC - that the SEPA process aims to replace national euro credit transfer and euro direct debit schemes with the SCT and SDD Schemes developed by the EPC. Based on statements of the European Commission in March and June 2010 [5], the EPC is very concerned that the Regulation as envisaged in related papers published by the EC to date[6] will deliver a different outcome.

According to the EC statements published in March and June 2010, the Commission now seems to embrace a radically different SEPA vision based on multiple "*new and competing credit transfer and direct debit schemes to emerge under the condition that they are compliant with the essential requirements*"[7] and discredits the SEPA payment schemes developed by the EPC at the request of regulators as a "*private monopoly*"[8]. The EPC does not share the EC's new outlook on the SCT and SDD Schemes and detailed the implications of a Regulation based on this new SEPA vision in the article "On Payments and Light Bulbs" in the previous edition of this newsletter (a link is included below).

The EPC acknowledges the recent indications of the EC to hold a public hearing on the most appropriate approach to regulatory intervention which aims to ensure swift migration to SEPA, as originally intended. It is the EPC's view that clarity on the meaning of technical terms and concepts related to the payment market is critical when discussing EU legislation applicable to the industrialised Straight-Through-Processing of a massive volume of payment transactions across the EU annually. It would be highly regrettable, to say the least, if SEPA - which is the most ambitious EU harmonisation project in the area of payments since the euro introduction - would fail because of confusion over semantics.

The meaning of "payment *instrument*"

Payment *instrument* means any personalised device(s) and / or set of procedures agreed between the payment service user and the payment service provider and used by the payment service user in order to initiate a payment order [9]. As such, credit transfers or direct debits, for example, are payment *instruments*. But often *devices* such as payment cards, which are used to initiate a debit transfer or to withdraw cash, are also called payment *instruments*.

The meaning of "payment *scheme*"

A payment *scheme* is a set of **interbank rules, practices and standards** necessary for the functioning of payment services[10]. **Payment *schemes* are developed** by payment service providers (PSPs) operating in a **cooperative and interbank environment.**

Delivery of euro credit transfer and euro direct debit payment services in each of the euro area countries operates today on the basis of a **single set of national payment *schemes* (rules and standards) for direct debit and credit transfer** developed by national communities of banks. This market reality has never been challenged on the grounds of general national public policy or by national competition authorities in EU Member States. The SCT and SDD payment *schemes* are developed by the European banking communities cooperating in the EPC. The SCT and SDD *Schemes* - as set out in the **SCT and SDD Scheme Rulebooks and the related Implementation Guidelines - contain sets of rules on the use of agreed standards for the execution of SEPA credit transfer and direct debit transactions** that have to be followed by payment service providers. These Rulebooks and the Implementation Guidelines can be regarded as **instruction manuals** which provide a common understanding on how to move funds (money) from account A in bank X to account B in bank Y within SEPA.

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Communication between the parties involved in the execution of a payment (payer, payer's bank, payee's bank and the payee) takes place based on so-called message standards or data formats[11]. The SCT and SDD Schemes are based on the global ISO 20022 message standards developed by the International Organisation for Standardisation (ISO). The ISO 20022 message standards (SEPA data formats) are binding for the exchange of SEPA payments between payment service providers to ensure reachability, as payments are a multi-party networking process. Implementation of the SEPA data formats in the customer-to-bank and bank-to-customer communication is not mandatory, but recommended.

The purpose of migration to a single set of SEPA payment schemes for euro credit transfers and euro direct debits

In essence, a **SEPA payment *scheme* can be compared to other frameworks which prescribe standardised processes to be observed by actors operating in network industries**: such standardisation - or integration - initiatives enable the provision of services by service providers in a two-sided market also across traditional boundaries (for example, national borders). An example of such integration initiatives are standardised **railway tracks** allowing a multitude of commercial railway operators to move their trains across borders. Similar examples of standardisation in network industries can be found in the areas of telecommunication, television or radio.

In the area of payments, also the introduction of the euro can be regarded as a means of standardisation. It needs to be kept in mind that the euro would never have become the common currency of today 16 EU Member States[12] if migration to the euro would have been left to market forces.

The purpose of migrating to a single set of harmonised SEPA *schemes* for euro credit transfers and euro direct debits can therefore be compared to implementing standardised "railroad tracks" for the exchange of payments across the European Union: The SCT and SDD Schemes represent the integration at a European level of the multiple sets of single national payment schemes existing today. **Migration to a single set of SEPA payment *schemes* would allow multiple payment service providers to offer a broad range of diversified payment *services and products* for euro credit transfers and euro direct debits SEPA-wide**. As a result, customers would benefit from increased competition and more choices in the payments market. Standardisation at the *scheme* level is the very precondition for increased competition and diversity of PSPs at the *services and product* level.

It should be recognised that **the scope of the current debate on migration to SEPA refers exclusively to the replacement of existing national euro credit transfer and euro direct debit *schemes* equivalent or corresponding to the SEPA Credit Transfer and / or SEPA Direct Debit *Schemes*.**

Several other payment *schemes* exist in the market today enabling payment services different from credit transfers and direct debits. These payment *schemes*, such as card schemes, will not be addressed in this context.

It should also be noted that the **EPC is a not-for-profit organisation and makes all deliverables available free of charge**, i.e. the SEPA Credit Transfer and SEPA Direct Debit Scheme Rulebooks and adjacent documentation are available for download on the EPC web site by any interested party. The **EPC is <u>not</u> a supplier of technology or any goods or services.** The **SCT and SDD *Schemes* developed by the EPC have <u>open access criteria</u>** in line with Article 28 of the Payment Services Directive (PSD). Last but not least, it should be kept in mind that **the SCT *Scheme* and the SDD *Schemes* are <u>not</u> commercial brands such as, for example, debit card or credit card schemes. Comparing a not-for-profit organisation with a de-facto monopoly is therefore erroneous and misleading.**

The meaning of "payment *services* and *products*"

The particular **payment *products and services*** - based on a particular payment *scheme* - offered to the customer are developed by individual PSPs operating in a **competitive environment**. PSPs are free to add features and services of their choice to the actual payment *products and services* in response to customer needs provided that the *product and services* respect the rules and standards of the relevant underlying payment *scheme*. The development of payment products based on the SEPA *schemes* including all product-related features such as pricing is outside the scope of the EPC. Therefore, **migration to harmonised SEPA *schemes* for euro credit transfers and euro direct debits does <u>not</u> imply migration to a single set of payment *products and services***.

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Migration to SCT and SDD does not curtail the rich variety of payment *products and services* available today. On the contrary: migration to a single set of harmonised SEPA *schemes* for euro credit transfers and euro direct debits will allow payment service providers to extend their diverse portfolio of commercial offerings to customers across SEPA. These will feature new, efficient and competitive products and services.

The meaning of "payment *system*"

Payment *system* means a **funds transfer *system*** with formal and standardised arrangements and common rules for the processing, clearing and / or settlement of payment transactions [13]. In other words, a funds transfer *system* **enables the exchange of funds (money) and messages between two payment service providers executing a payment transaction**. These funds transfer *systems* can be PSPs as well as separate business - public or private - entities (which may or may not be owned by banks[14]).

In the SEPA context, a payment *system* in the meaning of a "funds transfer *system*" is referred to as a "Clearing and Settlement Mechanism" (CSM). Services offered by competing CSMs based on the SEPA *schemes* are governed by market forces and are **outside the EPC's remit** as there is a clear separation between the EPC as the SEPA Scheme Manager and CSMs. The EPC approved the principles for the CSMs in its PEACH/CSM Framework [15]. Therefore, **migration to a single set of SEPA payment *schemes* does not and cannot imply migration to a single payment *system***.

The concept of "interoperable" SEPA payment schemes defeats the purpose of SEPA

To grasp the level of detail that needs to be agreed upon to ensure the proper, SEPA-wide functioning of a payment *scheme*, we refer, for illustrative purposes, to the SEPA Credit Transfer Scheme Rulebook, the SEPA Direct Debit Scheme Rulebooks and related Implementation Guidelines posted on the EPC web site. For any given payment to be correctly executed under a specific payment *scheme*, the scheme rules must be observed - at a minimum - by the following parties: the payer's bank, the payment *system* (CSM) facilitating the clearing and settlement of funds between two banks, and the payee's bank**. In the absence of such unique scheme rules observed by these parties, it is impossible to execute a payment**.

The **SEPA-wide Straight-through-Processing (no manual intervention) of a combined 33,3 billion credit transfers and direct debits in the euro area**[16] annually requires agreement on the business rules and standards governing the execution of euro payment transactions. **Payment services can only be delivered SEPA-wide** if the PSPs of all customers adhere to the exact same basic *scheme* rules and standards, i.e. **if banks are "reachable" based on their adherence to the same payment *scheme*.** Hence, integration of the currently fragmented euro payments market for euro credit transfers and euro direct debits requires that all PSPs adhere to the same SCT and SDD *Scheme*.

Creating "interoperability" of "multiple" SEPA *Schemes* for euro credit transfers and euro direct debits now considered by the Commission would require onerous multiple agreements at an extremely high level of detail to allow fully automated processing of payments across multiple payment *schemes.* This concept also puts at risk the fundamental requirement of full reachability of all PSPs across SEPA. In consequence, implementing this concept **would do little to overcome the fragmentation of the euro payments market and disregards the principles governing an optimally efficient payment environment**. In addition, it will not allow that PSPs are able to make a choice for their preferred CSM, where those CSMs adhere to different SEPA *Schemes*. Last but not least, establishing multiple SEPA *Schemes* would **rule out cost savings to the benefit of bank customers** resulting from the consolidation of cash management operations. Migration to a single set of SEPA *Schemes* for euro credit transfers and euro direct debits is the precondition for consolidation and full integration to take place

The concept of "multiple, competing, interoperable" SEPA payment *schemes* makes about as much sense as arguing that "competing" standards for railroad tracks would boost competition in the transport and cargo sectors. If the latter were to be introduced, the exact opposite would happen: train traffic would come to a grinding halt.

The bottom line is: no end date, no SEPA

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A last word on semantics: the EC recently indicated that the forthcoming Regulation related to SEPA would (1) be a response to the "*banking industry's request*" for such regulatory intervention and (2) should be regarded to set a " *start date*" for SEPA.

To set the record straight (again): firstly, the banking industry did not ask for SEPA to be created - the political authorities did. **Setting end dates for migration to the SEPA payment schemes developed by the EPC therefore accomplishes the political vision of an integrated euro payments market**. Secondly, the start date for SEPA - as recognised also by the former EU Commissioner Charlie McCreevy on that date - was 28 January 2008, the day the EPC launched the SCT Scheme. Therefore, **a Regulation aimed at establishing a "*start date*" for SEPA would be completely superfluous at this point, thank you very much.** The debate on setting clear deadlines for migration to SEPA through EU Regulation always related to setting end dates for replacing existing national euro credit transfer and euro direct debit schemes by the SCT and SDD Schemes.

To cut this long narrative short: while it is not the author's intention to call into question the intellectual capabilities of any party concerned, one cannot resist alluding to the revelations of a former US presidential candidate in the context at hand: *It's the End Date, Stupid*[17]. Unless clear dates are set through EU Regulation defining the point in time when SCT and SDD will replace existing national euro credit transfer and direct debit schemes, it is curtains for SEPA. End of story.

Gerard Hartsink is the Chair of the EPC.

If you attend Sibos 2010, do not miss the following event:

SEPA 2010: A small step for regulators, a giant leap for the integration of European payments?

Wednesday 27 October at 9 AM @ SIBOS conference - RAI - Ansterdam

Outline: *After years of hard work and milestones met by the European banking industry, some still tend to consider SEPA more a concept than an effective transformation project. Is the SEPA vision on its way to becoming reality and, if so, by when? SEPA stakeholders will exchange views on the state of global integration and standardisation for payments and cards in Europe, report progresses to date and obstacles ahead in light of the migration end date, assess whether the governance of the SEPA project is now appropriate and how the industry will need to move forward to realise the vision.*

Related links:

Commission services' Working Paper of June 2010 pertaining to a forthcoming binding Community instrument setting end dates for compliance of euro credit transfer and euro direct debit schemes with "essential requirements" and common standards

EPC Response to the Commission services' Working Paper of June 2010

European Commission Discussion Paper "SEPA Migration End-Date" of March 2010

Commission´s Third Survey on Public Administrations´ Preparedness and Migration to SEPA (October 2010)

EPC publication "Shortcut to Who is Who in SEPA" (new!)

Related articles in this issue:

Preparation for SEPA by Public Administrations in France. France's public administrations are among the country's leading users of cashless payment systems

The Quantum Leap for SEPA Direct Debit .From 1 November 2010, all banks in the euro area are reachable for SEPA Core Direct Debit

An Epic Voyage: the SEPA Odyssey. Looking to Homer provides useful insight on the integration of the euro payments market

Facing the Facts in October 2010. The EPC Newsletter tracks the progress of SEPA implementation

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Moving Forward. "Banks & Future 2010" identifies the trends shaping the European payments market

332 Votes for an End Date. Main findings of the European Payments Survey 2010 on SEPA and the PSD

Related articles in previous issues:

On Payments and Light Bulbs. Commission ready to write off SEPA via EU legislation? (EPC Newsletter, Issue 7, July 2010; this article analyses the Commission services' Working Paper "SEPA Migration End-Dates" published in June 2010)

Why change? Why me? Why now? The political mismanagement of the SEPA process reinforces resistance to change (EPC Newsletter, Issue 7, July 2010)

On SEPA and US Health Care Reform. The EC paper 'SEPA Migration End-Date': a commentary (EPC Newsletter, Issue 6, April 2010; this article analyses the Discussion Paper tabled by the European Commission in March 2010 outlining alternative approaches, including regulatory intervention, aimed at ensuring migration to SEPA)

On Bananas and the Integration of Euro Payments. The SEPA commitment of EU governments (EPC Newsletter, Issue 2, April 2009)

Cheer up: SEPA is on Track and open for Business. Market uptake is in line with roll-out of any major EU integration initiative (EPC Newsletter, Issue 1, January 2009)

1 On 25 October 2010, the publication date of this article, market uptake stands at 9.3 per cent for SEPA Credit Transfer and 0.05 per cent for SEPA Direct Debit according to the SEPA indicators published by the European Central Bank (ECB). The ECB SEPA indicators are publicly accessible at http://www.ecb.europa.eu/paym/sepa/about/indicators/html/index.en.html

2 The **Economic and Financial Affairs Council (ECOFIN - comprising the EU Finance Ministers)** considered "that establishing definitive end-dates for SDD and SCT migration would provide the clarity and the incentive needed by the market, ensuring that the substantial benefits of SEPA are rapidly achieved and that the high costs of running both legacy and SEPA products in parallel can be eliminated". The **ECB** repeatedly stated that setting a realistic but ambitious end date for migration to a single set of SEPA payment instruments is "a necessary step in order to reap the benefits of SEPA" (Speech by Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the EPC SEPA Direct Debit launch event on 13 October 2009 in Brussels: "Payments are becoming European"). In March 2009 and 2010, the **Europ** **European Parliament** called on the Commission "to set a clear, appropriate and binding end-date, which should be no later than 31 December 2012, for migrating to SEPA instruments, after which all payments in euro must be made using the SEPA standards". At its first meeting in June 2010, the **SEPA Council** endorsed a formal declaration stressing its "support for the establishment of end-date(s) for migration to SEPA Credit Transfers and SEPA Direct Debits by means of legislation at EU level". The objective of the SEPA Council chaired by the ECB and the European Commission is to promote the realisation of an integrated euro retail payments market by ensuring proper stakeholder involvement at a high level. The SEPA Council includes representatives of both the supply and the demand sides including the EPC.

3 The Quest for the Holy Grail? - European Financial Integration: Achievements and Hurdles. Speech by Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB. Workshop on 'Securing the Future Critical Financial ICT-Infrastructure (CFI)' organized by Parsifal. Frankfurt, 16 March 2009.

4 Retail payments are mainly consumer payments of relatively low value and urgency (ECB Payments and Markets Glossary).

5 European Commission Discussion Paper 'SEPA Migration End-Dates' of March 2010 and Commission services' Working Paper 'SEPA Migration End-Dates' of June 2010. See 'Related Links' above.

6 European Commission Discussion Paper 'SEPA Migration End-Dates' of March 2010 and Commission services' Working Paper 'SEPA Migration End-Dates' of June 2010. See 'Related Links' above.

7 European Commission Discussion Paper 'SEPA Migration End-Date' of March 2010 (PSMEG/002/10), section 2.3 (20), page 4.

8 European Commission Discussion Paper 'SEPA Migration End-Date' (PSMEG/002/10), section 2.1 (15), page 3. A.

9 Payment Services Directive (PSD); Article 4 (23).

10 European Central Bank Payments and markets glossary available at http://www.ecb.int/home/glossary/html/act6p.en.html#631

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[11] In the world of payments processing, the role of the data format used to exchange information between banks can be compared to the role of language in communication between people. Today, dozens of different data formats are in place to process payments across different national and European clearing systems in the European Union. The realisation of SEPA therefore requires agreement on a common set of data to be exchanged in a common syntax. The SEPA data formats as specified by the EPC for the exchange of SEPA payments like direct debits and credit transfers represent such a common data set. For further details refer to the EPC publication "Shortcut to the SEPA Data Format" available atwww.europeanpaymentscouncil.eu / SEPA Customers.

[12] Estonia will adopt the euro on 1 January 2011.

[13] Payment Services Directive (PSD); Article 4 (6).

[14] The term bank is used in a non-discriminatory fashion; i.e. it does not exclude payment service providers that are not credit institutions.

[15] Details are set out in the EPC's PE-ACH/CSM Framework. This Framework recognises that clearing of funds between PSP's can take place bilaterally or via a PEACH (Pan European Clearing House) or via a CSM (Clearing and Settlement Mechanisms). The PE-ACH CSM Framework is available for download on the EPC web site.

[16] ECB Blue Book (2009).

[17] "It's the Economy, Stupid" is a phrase introduced into American politics during Bill Clinton's successful 1992 US presidential campaign.

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