ECRI SEMINAR ON

PSD AND SEPA: DESIGNING THE WAY FORWARD FOR EUROPEAN PAYMENTS

Minutes

European Credit Research Institute at the Centre for European Policy Studies
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in cooperation with VISA

The Payment Services Directive (PSD) was published in late 2007, constituting the legal basis for the Single Euro Payments Area (SEPA). The industry initiative launched on 28 January 2008 is aiming at replacing fragmented national markets for payment services with one integrated system.

While deadlines both for the transposition of the PSD into national law and the full availability for SEPA standards are set, many other questions lack clear answers and need to be addressed accordingly. Given the numerous directives and different regulations affecting payment services providers, the partial duplication and interlinkages between the various provisions are prone to create a legislative labyrinth. What is the scope of the new directive? To what extent will business models have to be reviewed? Will consumers be sufficiently protected? What standards for the various SEPA schemes will be have to be implemented? How are (smaller) banks with little cross-border activities affected? Who will benefit?

Due to the high importance of these issues, the European Credit Research Institute has commissioned two papers, which formed the basis of the discussion at the workshop. Prof. Dr. Maria Chiara Malaguti will focus and elaborate on the legal implications arising from the adoption of the PSD, and Prof. Dr. Jürgen Bott considered the requirements for new business models in SEPA.

After one year of work on the implementation of the PSD and with SEPA soon to celebrate its first anniversary, the workshop also aimed at assessing what has so far been achieved and – more importantly at this critical state – where further obstacles lay.

More information can be found at www.ecri.eu.

European Credit Research Institute (ECRI), 1 Place du Congrès, B -1000 Brussels, Belgium
Tel: +32-(0)2-229.39.11, Fax: +32-(0)2-219.41.51, e-mail: info@ecri.be, web: www.ecri.eu

Karel Lannoo, CEO of the Centre for European Policy Studies (CEPS) and the European Credit Research Institute (ECRI) chaired the event and welcomed all participants on behalf of ECRI. In his introductory remarks, **Mr Lannoo** explained that due to the topicality of the subject a little less than a year ago – shortly after the publication of the Payment Services Directive (PSD) in 2007 and just before the launch of the Single Euro Payments Area (SEPA) on 28 January 2008 – ECRI, together with Visa Europe, had decided to organise a workshop whose basis of discussion should be two papers covering both issues. He pointed out that now, almost a year later and in the midst of the financial turmoil, the importance of addressing the topic had not diminished due to the re-focus of financial institutions on the retail side of their business and the estimated huge benefits that could be reaped by successfully pushing forward the implementation of SEPA. Referring to the requirement of broad support for the project both on the supply and the demand side in order to efficiently move towards the new regime, he lamented the almost complete lack of advertisement for SEPA in the past years that would be necessary to achieve critical mass.

In the first presentation of the workshop, **Marc Temmerman (Executive Vice President, Visa Europe)** welcomed the thrive towards the construction of an integrated internal market for payments, pointing at the potential advantages of increased choice, competition, efficiency, convenience and security that would come with the success of SEPA.

Predicting that in a few years, changes of the market landscape determined by the regulatory framework could be enormous and lead, for example, to a convergence of card and ACH (Automated Clearing House) processing or reduce the number of ACHs, **Mr Temmerman** emphasized that the projected benefits could not be reaped without work on the realization of a number of conditions.

He advertised the need for interchange fees, the "cornerstone of the four party-model", elaborating on the fact that the supply of payment services was a "commercial business which needed to be financially self-sustaining" in order to ensure investments in innovation, efficiency and security. The guarantee of a level-playing field as a "prerequisite for an open, fair and competitive market" in which all players were bound by the same rules was another condition to be fulfilled, similar to the need to equitably distribute costs and benefits among all stakeholders (for example by allowing banks to charge cash services and other payment means in relation to costs incurred). Furthermore, he welcomed the PSD as a "positive step forward" on the way towards greater legal consistency and certainty, yet another precondition for the realization of the integrated market for payments. Calling on the industry to "get together and work together", **Mr Temmerman** pointed at the inevitability of constant investment and work on increasing the level of security in the payments market. He concluded his presentation by pointing at Visa Europe's response to the SEPA project, mentioning the progress achieved in terms of governance and compliance with the SEPA Cards Framework,

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In the following speech, **Maria Chiara Malaguti (Professor at the University of Salento)**, presented the first draft of her paper "The Payment Service Directive: Between *Acquis Communautaire* and National Implementation". Taking into consideration the comments from the workshop and revised accordingly, the paper will be published as ECRI Research Report No. 9. **Ms Malaguti** underlined the inherent difficulty of trying to "solve problems without creating new ones" when drafting a comprehensive piece of legislation like the PSD. She stated that policy makers were confronted with the unprecedented exercise of detaching the service of transferring money from traditional financial services while at the same time drawing up common rules for such a transfer independently of the means used. As a result, the adoption of the PSD gave rise to a number of criticalities as regards its interaction with other Community legislative acts and the *acquis communautaire*, some of which **Ms Malaguti** subsequently elaborated upon.

In addition to imposing transparency requirements in the provision of payment services and establishing rights and obligations of both service providers and users, the PSD attempts to set out categories of authorized providers of payment services (credit institutions, e-money institutions (EMI), as well as the new category of "payment institutions" (PIs)) but fails to clarify – with regards to existing legislation like the Capital Requirements Directive (CRD) or the E-Money Directive – both what exactly a payment services is and what qualifies an institution to be a payment service provider. Inserting a new set of (prudential) requirements for PIs and thereby choosing not to interfere with existing requirements for credit- or e-money institutions might, according to **Ms Malaguti**, result in a barrier to a level playing field. She stated that despite offering the same service – providing money to execute a payment – EMIs were receiving a different treatment under the E-Money Directive (Directive 2000/46) than PIs under the PSD, leading to a certain level of discrimination, which would be only partially reduced if the Commission proposal from 9 October 2008 reviewing the current E-Money Directive was adopted.

Applying various graphics in order to visualize the basic structures of payment service provisions (see presentations downloadable at www.ecri.eu), **Ms Malaguti** used the example of mobile banking to test the legal framework provided by the PSD and the proposed amendment of the E-Money Directive against concrete schemes. She differentiated between a scenario in which a customer had its own bank account (against which a payment transfer was immediately settled) and the scenario in which the mobile network operator (MNO) itself had an account (which it held in its own name but on behalf of all and each of its clients). Whereas "no doubt exists" that the bank is a credit institution under Directive 2006/48, the question remains whether the bank or the MNO under the PSD (and the E-Money Directive) is the actual payment service provider in the second hypothesis. **Ms Malaguti** argued that both the bank and the MNO could be abstractly qualified as such – depending on the reading of the PSD and the modification of some elements of the underlying example -, and consequently create ambiguities on regulation of the specific situation. Elaborating on her own personal opinion, **Ms Malaguti** argued that the qualification of an institution as a service provider should not depend on direct or indirect contact with a customer (as the PSD seems to assume) but on whether or not the institution got into possession of funds. She subsequently motivated the audience to approach her with opinions, suggestions

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and advice in that matter. Moreover, Mrs Malaguti questioned the treatment of "niche" three-party systems, saying that in order to ensure a level playing field both three-party and four party systems shall have been looked at in the same way in Art 28 about access to payment systems.

Towards the end of her presentation, **Ms Malaguti** drew the attention to problems arising as regards the scope of the PSD, describing that although the PSD applies to any payment service provided within the Community, provisions under Titles III (transparency requirements) and Title IV (on rights and obligations) only apply when both payment service providers are located within the Community. While this, in here view, is understandable for provisions affecting legal consequences and enforceability of payment transactions requiring certain (technical) standards, its "limitation relating to transparency of information and charges" (and hence consumer protection) seems much less evident.

Concluding, **Ms Malaguti** stated that the "high degree of autonomy" left to Member States by granting a whole range of derogation powers (institutional derogations as well as derogations linked to behaviour or for national transactions) might proof beneficial in terms of necessary flexibility in order to cope with the continuous evolution of the field, but could also "further compromise" the general architecture of the PSD.

At the beginning of his speech, **Jürgen Bott (Professor at the University of Applied Sciences of Kaiserslautern)** drew the attention to the "impressive economic benefits" of the SEPA project, which the Commission regards as a important contribution to the Lisbon agenda, aiming at making Europe the most competitive and knowledge-driven economy by 2010. He stated that the European banking industry had declared to realize SEPA the way the Commission and European Central Bank had envisaged the project, namely "in a self-regulatory process which is driven by market forces", implying that banks were to create the economic impetus necessary to motivate market participants to migrate from national standards to new SEPA schemes. Depicting the payment services industry as a network industry with the potential to tap new sources of realizing economics of scale and scope, **Mr Bott** argued that increased efficiency, reduced risk and improved convenience would generate benefits for both service providers (taking advantage of cost reductions by synergy effects) and users (taking advantage of price reductions passed on to consumers by market forces and/or competition regulation), thus acting as the required impetus. As banks served very heterogeneous markets (e.g. the absence of interchange fees for direct debits in Germany vs. its importance in the French system), the realisation of economies of scale and/or scope were limited, according to **Mr Bott** who characterised the argument of "the bigger the market, the more economies of scale and scope" as "too simple". Arguing from a management point of view and dampening the prospects for rapid changeover, he stated that before banks were ready to realize economies of scale and scope, "preliminary work had to be done on at least three layers within an organisation":

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a) On the level of operational strategy, the management of service providers had to recognize SEPA as a source of potential benefit, achievable only by "giving SEPA a higher priority and accepting investment and innovation as an acceptable strategy".

b) In terms of technical and procedural readiness, strongly interwoven processes within one individual banking group, referred to as "monolithic blocks", had to be split up into smaller and more independent sub-processes which will be easier to isolate and reallocate (unbundling) between various European service providers. According to **Mr Bott**, the challenge remained to provide the incentives to "break-off such well-functioning local optimisation for the sake of the vision of and even better optimisation in a still somewhat vague SEPA".

c) Organizational behaviour would create further (managerial) problems, with employees reluctant to change and discontinuity of familiar organizational structures and technologies. **Mr Bott** thus argued that it was indispensable for leaders to provide the individual stakeholders "with a story to believe in" as well as "the understanding that SEPA will improve the current situation".

As regards the necessary investments, **Mr Bott** argued that "operational bankers do not have the reputation to be very innovative". He continued by stating that "banks need to realize that they need to reduce costumers cost first as well as increase their convenience and security". Living up to their expectations and fulfilling unsatisfied needs was, according to **Mr Bott**, a potential source for additional revenues as enhanced products and services would subsequently justify higher prices.

Mr Bott concluded that due to the network industry nature of the payment systems industry "new alliances" were necessary to tip the market and a "shift in paradigm" in order to successfully move to the new schemes. To that end, banks were dependent on support from mayor customers and suppliers ('trustful allies'). Other indispensable aspects were a) the work on convincing customers, suppliers and producers of complementary products of the potential benefits of SEPA, b) the readiness of participating organisations for short innovation cycles, c) "intelligent solutions to distribute the generated value among the partners of the alliance" as well as d) compatibility to already existing national standards. Moving towards "the innovative paradigm in which the costumer is king" and in which performance, leadership and a constant process of innovations were rewarded would, according to **Mr Bott**, lead to the kind of SEPA driven by market forces and envisaged by the Commission and the ECB which eventually "delivered the promises of the Lisbon Agenda". Otherwise, "the project would be nothing more but the solving of a technical problem and some kind of interlinking".

In the following discussion, **Mr Temmerman** warned to be "overly optimistic" as regards the realization of the SEPA project and the potential benefits eventually brought along. In addition, he argued that there was "no better time than now" to invest in innovation and new technologies, in order to "be ready to reap the benefits once things start speeding up" in two years time. **Mr Bott** agreed that despite the current difficult circumstances and financial constraints of financial

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institutions, the “crisis should not be an excuse” for slowing down or even stopping the process of change to SEPA schemes.

Starting off her intervention, **Ruth Wandhöfer (Payments Industry & Strategy, EMEA Cash management, Citi)**, stated that “banks needed clarity in terms of a harmonized legal framework”, pointing at the vast derogation powers granted to the Member States as one of a number of critical issues arising from the transposition of the PSD into national laws. In her view, the PSD was “blown out of proportion”, leading to interesting and complex discussion on how to correctly interpret the text in stakeholder conferences like the PSD Transposition Workshops in which regulatory best practices were also being shared. Moving quickly towards the implementation deadline in November 2009 and given a variety of parallel initiatives (e.g. the PSD, SDD, SCT, etc.), she argued that “many institutions may not be able to comply anymore”, effectively leading to greater outsourcing activities rather than new market entries. Adding to the already high levels of uncertainty was the fact that although the PSD has not even been implemented into national law across Member States, “people [DG MARKT and an increasing number of Member State finance ministers] already talk about changing the PSD”. **Ms Wandhöfer** mentioned that SEPA would certainly bring about certain benefits, especially arising from economies of scale and scope, but given the current status of “infancy” of the project, these were more likely to be reaped in 5-10 rather than 2-5 years.

Christian Westerhaus (Managing Director Deutsche Bank AG Global Transaction Banking, Head of Product Management - Financial Institutions) explained in the beginning of his presentation that in February 2006, Deutsche Bank had chosen to follow an “integrated approach” rather than a “minimum compliance approach” for ten different countries as a response to the SEPA project. He stated that Deutsche Bank had decided “from the start to retire legacy systems in two years and not by 2013/2014”. Underlining the necessity of creating one integrated EU clearing structure rather than a continued co-existence of numerous platforms with small amounts of transactions, **Mr Westerhaus** praised the ECB to “have done a good job” in setting up the well-functioning TARGET2 joint gross clearing system. As regards a roadmap to achieving SEPA, **Mr Westerhaus** pointed out that “some pillars exist” but that the system was still lacking a higher volume of transactions. To that end milestones, such as a corridor for a migration end date, had to be defined, also in order to “avoid surprises when the volumes kick in”. In addition, further issues had to be solved such as the issue of interchange fees for direct debit transactions. He acknowledged the validity of an interim period during which such interchange fees could be charged but stated that it was necessary to define its length. In his opinion, a time frame of “four to five years” would be appropriate. By defining a detailed roadmap and scope of the project, working on finding “pragmatic solutions” and looking at ways to “gradually move some elements” of the SCT scheme, **Mr Westerhaus** argued that a costly “late rush” and “unnecessary frictions for corporates” could be avoided, subsequently raising the chances of reaping greater benefits from a migration to SEPA.

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Asking if cost saving potentials existed and whether the current SEPA environment stimulated innovation, **Mr Lannoo** opened a short discussion round. **Mr Westerhaus** stated by retiring legacy systems, cost savings amounting to "low double digit million Euros per annum" were projected. Especially in terms of access channels to banking services, SEPA triggered discussions that some inefficient channels could be closed. This, however, was subject to a detailed analysis concerning the current usage and potential cost savings of shutting down certain channels before being able to make such a decision. Adding to this, **Ms Wandhöfer** remarked that closing Eurozone domestic Automated Clearing House (ACH) infrastructures and instead using 2 to 3 Pan-European clearing houses would also contribute to greater efficiency and reduced costs. As regards the aspect of innovation, **Mr Westerhaus** explained that neither credit transfers nor direct debit transactions were new innovations, stating that even if carried out by mobile phone, the nature of the supplied service remained the same. Hence, necessary innovations included the finding of new and more efficient access channels, providing customers with more convenience and security. **Ms Wandhöfer** argued that innovations are typically observed in an "unregulated space". To that end the PSD, characterized by **Ms Wandhöfer** as "not proactive" and a "limiter", has the potential of constraining innovation within the regulated space.

In the last presentation of the day, **Heiko Schmiedel (European Central Bank)** emphasized the potential economic effects of SEPA, whose realisation could lead to the creation of a competitive and fully integrated European retail payments market. The current financial turmoil caused banks to reconsider their business model and to concentrate on their core business, i.e. retail banking and payments services. He stated that the Eurosystem welcomed the substantial efforts so far undertaken by the European banking community, for example in the setting up of the SEPA credit transfer scheme (SCT), the preparations for SEPA Direct Debit (SDD) as well as the work on electronic- and mobile payments. However, the Eurosystem observed that some energy is fading away from the project. Some final hurdles yet need to be overcome. As regards SEPA for cards, the Eurosystem would welcome at least one additional European card scheme to emerge.

In the concluding discussion, and responding to to **Mr Lannoo's** question if "more regulation" would be the answer to a failure of the SEPA project, **Mr Schmiedel** stated – with regard to an end-date for migration – it needed to be seen if this will be achieved by self-regulation or regulation. **Mr Bott** subsequently pointed at the "often ignored fact" an "quasi"-end-date for SDD (November 2009) had already been set.

Ms Wandhöfer explained that a substantial amount of corporate clients were aware of the SEPA benefits and "want it now". However, while banks have begun to deliver and market SEPA credit transfers it currently appears that a number of key governments in Europe did not provide their full support to SEPA, thus limiting the speed of SEPA migration.

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Concluding on various issues discussed, **Mr Westerhaus** stated that while the SCT worked "more or less", some banks still "needed to speed up". As regards direct debits, he explained that the existing scheme in Germany was already PSD compliant, while substantial work was necessary in other countries, especially in terms of outreach, which was a "key issue for the success of the SDD scheme". In that vein, progress needed to be achieved in the transposition of the PSD and the discussion of the direct debit interchange fee issue. Problematic, in his view, was the fact that the European Payments Council needed to "manage the outreach but cannot force or mandate the banks to join the scheme".

The workshop was concluded by **Mr Lannoo**, who thanked the two professors for their valuable papers, as well as the invited speakers and the audience for interesting presentations and discussions.

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