

# Towards a uniform service level for retail payments in the euro area

*Efficient and reliable cross-border payments in the euro area are essential for the smooth functioning of the Single Market. The benefits that can be reaped from the application of the principles of free movement of goods, services, capital and people indeed depend in part on the speed, security and cost of transferring money.*

*The introduction of the euro was an important step on the road towards completion of the Single Market. Currency borders have vanished and all payments within the euro area should be considered “domestic”. In the area of large-value payments, truly cross-border systems like the Trans-European Automated Real-time Gross settlement Express Transfer (TARGET) system and Euro 1 provide efficient payment processing in the EU and have contributed to the integration of euro money markets. As from the beginning of next year, euro banknotes and coins will be legal tender within the whole euro area, thus making them equally usable in a national and cross-border context. In the area of non-cash retail payments, however, considerable efficiency gaps still exist between the processing of domestic and cross-border payments.*

*The Eurosystem has defined objectives for cross-border retail payments that should be met by 2002 at the latest. It has collaborated intensively with the banking sector to remove the obstacles which the banking industry identified as being responsible for the inefficiency of cross-border retail credit transfers in the euro area. Progress has been made, but the Eurosystem objectives have clearly not yet been achieved.*

*The Eurosystem remains firmly committed to making the euro area as a whole into a true single payment area. It monitors the developments in cross-border retail payments closely and will assess the situation again in early 2002. If necessary, further action will have to be taken to ensure the smooth functioning of retail payment systems in the euro area.*

## I The role of central banks in retail payments

Central banks have always been involved in retail payments, i.e. payments of limited value between consumers and between consumers and businesses. In the 19th century, many central banks were created with the specific aim of ensuring public confidence in banknotes – a retail payment instrument which, unlike coins, was not supported by its intrinsic value. In the course of the 20th century the use of commercial bank money (deposits with commercial banks) developed together with the instruments which support its transfer (cheques, credit transfers, direct debits and card payments) and with the systems where such instruments are exchanged and settled at the interbank level. Again, in order to ensure public confidence in payment systems based on the exchange of commercial bank liabilities, all central banks play a role in retail payments in providing the ultimate settlement asset, i.e. central bank liabilities. In addition, some

central banks have also retained a direct operational involvement in the field of retail payments.

As a consequence of the monetary policy function of a modern central bank, monitoring the impact of the functioning of payment systems on monetary policy and on systemic stability has become an additional key element of its basic task of ensuring the smooth operation of payment systems. This latter task is increasingly codified in law. For the Eurosystem, it is confirmed by Article 105 (2) of the Treaty establishing the European Community and Article 3 of the Statute of the European System of Central Banks and of the European Central Bank (the “Statute of the ESCB”). Moreover, Article 22 of the Statute of the ESCB explicitly grants regulatory powers to the ECB and allows for an operational involvement of the Eurosystem in payment systems. These provisions apply

to both retail and large-value payment systems.

For the past decade, the attention of central banks has focused to a large extent on systemic risk arising from large-value payment systems. After the adoption of the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (the "Lamfalussy Report") in November 1990, central banks stepped up their efforts to contain systemic risk by improving the safety and reliability of large-value netting systems and by developing real-time gross settlement (RTGS) systems and encouraging banks to use such systems for high-value payments. In line with this policy, the Eurosystem has created TARGET, the RTGS system for the euro.

Central banks' endeavours in respect of large-value payment systems may have led to the impression that they see their role as referring exclusively to these systems. This is, however, clearly not the case since retail payments remain an important part of their task today. In particular, given that efficient retail payment systems are essential for the economy, major central banks have addressed efficiency considerations in their payment systems policies. In the United States, the role of the Federal Reserve in

retail payments is not only reflected in the Federal Reserve Act but was also confirmed in 1998 by a committee headed by Alice Rivlin, Vice Chair of the Board of Governors of the Federal Reserve System. The committee confirmed the operational role of the Federal Reserve in providing cheque collection and automated clearing house (ACH) services. It also recommended that the Fed play a more active role, collaborating closely with providers and users of the payment system, both to enhance the efficiency of cheque and ACH services and to help evolve strategies for moving to the next generation of payment instruments.

Efficiency in payment systems is also of utmost importance for the Eurosystem. In a market economy, efficiency problems should preferably be solved by market forces. Public authorities, including central banks, should intervene only when the market fails. Efficient payment systems always presuppose a certain level of co-operation among commercial banks, and central banks typically act as catalysts in fostering such co-operation, a strategy which has proved effective in most countries. Therefore, the Eurosystem regularly invites the euro area banking community to exchange views and reach a consensus on how to improve payment services.

## **2 The present situation in cross-border retail payments is not satisfactory**

Currently, a total of approximately 100 million domestic retail payments are processed daily in the euro area. The number of cross-border retail payments is significantly lower, probably only a few hundred thousand per day, most of which are card payments.

For credit transfers, the instrument that is most suitable for remote payments (when the payee and the payor do not physically meet), the efficiency level is remarkably low in the cross-border context compared with domestic standards. For cross-border payments, fees are substantially higher and

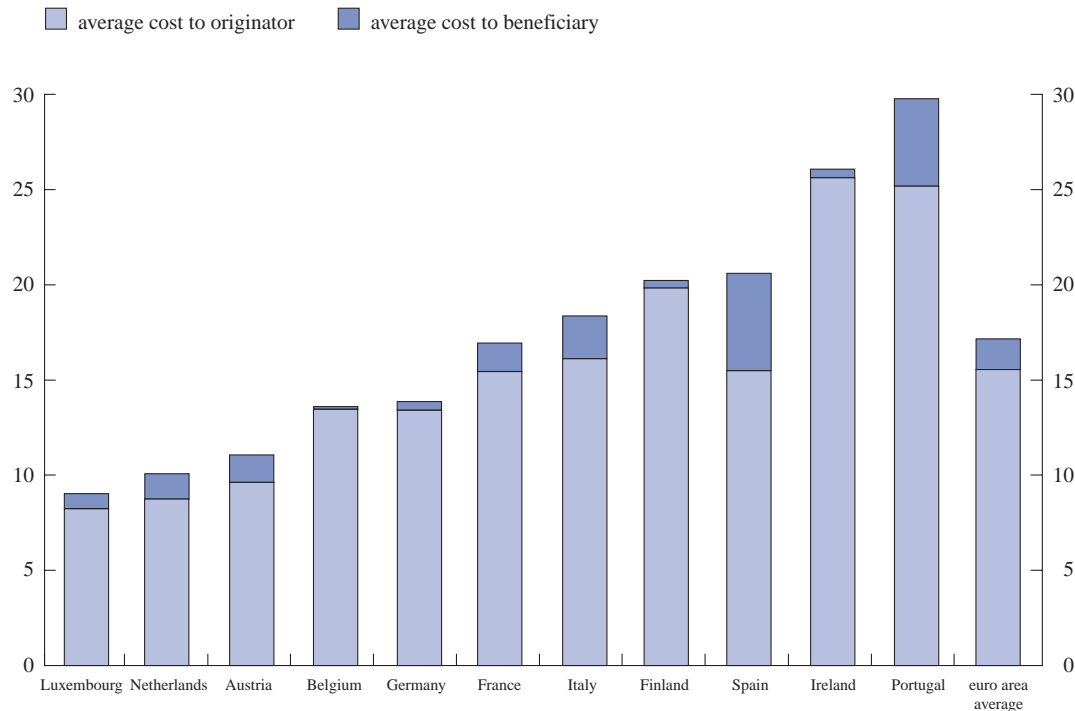
execution times much longer than for domestic ones.

A report entitled "Bank Charges in Europe" released by the European Commission revealed that in November 1999 the average fee charged to the originating customer for a €100 cross-border credit transfer was €15.51. Taking into account that in 25% of the cases additional fees were also charged to the receiver, the total cost of such credit transfer averaged at €17.10 (for further details and a country breakdown, see the chart below). This fee is about 40% lower

## Chart

### Average cost for cross-border retail credit transfers in the euro area

(in euro)



Source: "Bank Charges in Europe", a report released by the European Commission (Directorate-General Sanco), B5-1000-99/074610, IEIC, April 2000.

than the fee ascertained in a study of the European Commission in 1994, but it still amounts to roughly 100 times the charges for domestic credit transfers, which rarely exceed the range of €0.10 to €0.20. It is obvious that such fees are prohibitive for some segments of cross-border trade and service provision.

With regard to the execution time for cross-border retail credit transfers, some improvements can be noted. The average settlement time recorded in the above-mentioned report was 3.41 working days. In

a few cases, however, the execution time was still inadmissibly long (see the table below).

The major causes of the present unsatisfactory situation are the internal organisation of banks and the communication interface with the customer. Non-standardised customer interfaces and a low degree of automation in banks' internal systems and procedures explain a large part of the costs. Even when the sender provides its order electronically, the formats chosen are rarely compatible with the formats used by the bank of the recipient. Moreover,

## Table

### Execution time of a credit transfer in the euro area

1 day	2 days	3 days	4 days	5 days	6 days	>= 7 days	Average
6.04%	28.70%	25.68%	16.62%	13.60%	4.23%	5.14%	3.41 days

Source: "Bank Charges in Europe", a report released by the European Commission (Directorate-General Sanco), B5-1000-99/074610, IEIC, April 2000.

because customers do not always have all the relevant information for the transfer to be performed appropriately, many cross-border payments have to be “rectified” by the banks at great cost. In this respect, the customers themselves can also contribute to a more efficient service level by taking sufficient care in completing credit transfer instructions.

Another important reason lies in the predominant recourse to correspondent banking that often involves manual processing with a significant impact on cost and speed. In a domestic context, correspondent banking has been replaced by

multilateral payment system infrastructures. The same has happened in the euro area for large-value payments – e.g. those made via TARGET or the Euro I system, which is a large-value payment system developed by the Euro Banking Association (EBA). Infrastructures for cross-border retail payments in the euro area are still in their infancy. Banks use correspondent relationships today because, inter alia, they process customer transactions in legacy currencies via these channels. The cash changeover in 2002 should contribute to a reduction in correspondent banking and an increased use of more advanced retail payment infrastructures in the euro area.

### **3 The Eurosystem’s strategy and objectives: cross-border retail payments have to reach domestic service levels**

In order to preserve fully the economic function of money, euro claims in commercial bank money have to be entirely interchangeable and perfectly substitutable with claims in central bank money (i.e. cash and deposits with the central bank), as is the case in a national context. In other words, indifference between commercial bank money and central bank money must be achieved at the euro area level for all kinds of payments.

For payments in central bank money between banks, a uniform payment area has largely been accomplished through TARGET. Cross-border credit transfers are executed via TARGET in real time and thus at a similar speed to domestic payments. The average price for a TARGET cross-border transfer is about two and a half times the price of a domestic transfer, reflecting the aim of recovering costs. The Eurosystem is, however, committed to further improving and harmonising the TARGET system and making it more cost-efficient.

For payments in central bank money among citizens (cash payments), the Eurosystem and the banking industry are making a major effort in preparing for the introduction of euro banknotes and coins at the beginning

of 2002. This will ensure that, for cash payments, the euro area will then have become a true “domestic” payment area and the notion of “cross-border” payment will have lost its meaning.

As regards cross-border retail payments in commercial bank money, the banking sector had not given sufficient attention to this important aspect of the changeover to the euro. This has led to the present unsatisfactory situation regarding cross-border retail payments, which the Eurosystem started to address in 1999.

The European Parliament, also very concerned about this situation, has urged the ECB to become operationally involved in cross-border retail payments and to provide European citizens directly with such services. In this respect, it has also been suggested that TARGET could be used to process cross-border retail payments. Actually, TARGET is not only processing interbank payments but also customer payments. The number of cross-border customer payments in 2000 doubled to reach 14,000 payments per day. However, such payments are primarily high-value corporate payments (with an average value of €1.1 million) and cannot be considered retail in this

context. For retail payments of limited value, the present TARGET system may be too costly, as payments are processed transaction by transaction instead of in “batches”.

The Eurosystem has not ruled out the option of becoming more operationally involved than at present. However, in a market economy the banking sector should be able to provide the essential facilities for transferring commercial bank money in a speedy and cost-efficient manner. The Eurosystem, building on the

experience gained in domestic environments, felt that a market-based, co-operative approach with banks was most appropriate for achieving substantial progress and thus decided to act as a “catalyst for change”. It supported banks in preparing the ground for viable private solutions and, in September 1999, published its report “Improving cross-border retail payment services in the euro area – the Eurosystem’s view”. This report set seven objectives that banks were encouraged to achieve by 2002. These objectives are listed in Box I.

#### Box I

##### Eurosystem objectives for cross-border retail payments

- Objective 1: Enhanced system(s)/services should be ready by 1 January 2002.
- Objective 2: Priority should be given to cross-border credit transfers.
- Objective 3: The price of cross-border credit transfers should decrease substantially.
- Objective 4: Settlement time should be comparable for domestic and cross-border payments.
- Objective 5: For cross-border credit transfers, as a default rule, fees are to be borne by the originator of the payment only.
- Objective 6: Access to cross-border retail payment systems should be open.
- Objective 7: Existing standards should be implemented as soon as possible.

## 4 Progress in removing the obstacles and outstanding issues

The Eurosystem has collaborated intensively with the banking industry to identify, and where possible remove, the obstacles to enhanced cross-border retail payment services.

First, banks claimed that there was *no business case* for improving cross-border retail payments in the euro area. The argument that the prices are high because the traffic is low can, however, easily be turned around: traffic is low because prices are high. In addition, it is likely that there is no business case either for any domestic payment between villages in two remote regions in the same country. The Eurosystem made it very clear that even if there were to be no business case, efficient cross-border retail payments are an integral part of the changeover to the single currency. The cost of improving the service for cross-border

retail payments should therefore be seen in the perspective of the overall benefits of the single currency.

Second, there was inadequate *interbank infrastructure*. To make up for this deficiency, the banking sector developed a new initiative called STEP I, a cross-border low-value credit transfer system. This system was launched on 20 November 2000 and uses the infrastructure of the EBA Euro I system. The Eurosystem welcomed the STEP I initiative as it has the potential to improve cross-border retail payment services. Its actual contribution to the achievement of the Eurosystem’s objectives, however, can only be evaluated to its full extent once STEP I has been operating for some time.

Third, with regard to *common standards*, internationally valid account numbers and

payment instructions have already existed for some time. To be able to process cross-border retail transactions fully automatically, the only missing link was an appropriate format that could be used to transmit the payment messages between the banks involved. The Eurosystem fostered discussions that led to the creation of a payment message that allows fully automated processing ("straight-through processing" (STP)) of all payments throughout the euro area. This payment message was introduced into the SWIFT system, as well as in TARGET and the EBA's Euro 1 and STEP 1 in November 2000. This means that all technical prerequisites for a fully automated processing of cross-border retail payments in the euro area are now in place. Banks, however, seem somewhat reluctant to implement the standards quickly because investments are substantial and banks will only fully benefit from these investments once other banks have followed such implementation and the standards are commonly used.

Fourth, banks highlighted the difficulty for the receiving bank to recover costs if the customer ordering a cross-border transfer is to pay all the charges to the sending bank. That is why the practice of charging both the sender and receiver of a transfer, even in cases where the sender had committed to paying all the charges, would seem difficult to eradicate. This phenomenon, called "double-charging", is prohibited by the Directive of the European Parliament and of the Council of 27 January 1997 on cross-border credit transfers (97/5/EC). The above-mentioned report on "Bank Charges in Europe" revealed, however, that this practice is still used in 25% of all cross-border credit transfers. The Eurosystem has urged banks to come up with a short-term solution and the banking sector has started to define a default multilateral interbank exchange fee (MIF). This common MIF would cover the costs of the service of the receiving bank and would be added to the amount of the transfer. The MIF could be a short-term solution to the problem of "double-charging", provided that it is low and that it fulfils

the criteria set by the European Commission for the granting of an exemption from Community competition legislation.

Last but not least, a reason that has been frequently cited by the banks to justify the high fees for cross-border retail credit transfers is the obligation to report such transfers for the purpose of *balance-of-payments (b.o.p.) statistics*. This reporting quite often requires manual processing and thus interferes with fully automated processing. The Eurosystem initiated discussions with the banking sector and statistical authorities to decrease the cost of b.o.p. reporting. As a result, a common minimum exemption threshold of €12,500 was agreed, below which reporting will no longer be required as from 1 January 2002. In addition, harmonised economic codes for cross-border payments will facilitate the automation of the reporting. This will eliminate not only the administrative burden for banks in the vast majority of their cross-border retail payments but also a main justification for their charging high fees.

This brief review suggests that the conditions have now been met for the banking industry to reduce substantially (and in the long run eliminate) differences in price and speed between domestic and cross-border retail payments. The Eurosystem evaluated achievements made since 1999 in a progress report entitled "Improving cross-border retail payment services", published in September 2000. In this report, the Eurosystem acknowledges that progress has been made but observes that the objectives defined in the 1999 report have clearly not yet been achieved. Therefore, the Eurosystem urges the banking sector not only to maintain its efforts but also to reinforce them and, in particular, to adopt four action points (see Box 2).

The Eurosystem will closely monitor the banks' progress and compliance with the four action points. Compliance with the action points to be fulfilled by the end of 2000 is currently under review. The Eurosystem will

## Box 2

### Points for banks' immediate action

1. The payment infrastructure providers and the banks should publicly commit by the end of 2000 to the implementation of STP standards and have these standards implemented by mid-2001.
2. The banking sector should cease, with immediate effect, the unlawful practice of "double-charging" and find a practical solution to the underlying problem. If the MIF is adopted by the banking sector for this purpose, it should be implemented by mid-2001.
3. The banking sector should define a standard cross-border credit transfer product with a common name, which would contain the "basic" cross-border payment service offer, fulfil the Eurosystem's requirements and which most of the banks would provide. This product should be implemented by mid-2001 at the latest and its roll-out should be accompanied by a marketing campaign.
4. The banking sector should launch information campaigns targeting private and corporate customers in order to inform them about the standards and the information which should be included in invoices and payment orders. The banking sector should elaborate a practical proposal for this campaign by the end of 2000.

continue to play its "catalyst" role in this matter throughout 2001, reassess the situation continuously and publish its evaluation in early 2002. The focus is, however, not limited to short-term objectives.

## 5 Conclusion

In early 2002, the introduction of euro banknotes and coins will transform the euro area into a domestic payment area for cash payments. European citizens will be able to make payments in central bank money easily and efficiently throughout the euro area. They rightly expect that it will be possible to make all retail payments in commercial bank money at equal cost and speed throughout the euro area, i.e. that the criterion of indifference between commercial and central bank money will be fulfilled. At present, the banking sector is a long way from meeting that goal.

The Eurosystem has defined objectives and action points to make sure that substantial improvements can be achieved by 2002. It fostered discussions with relevant parties and helped to remove the causes of the high prices and low service level of cross-border retail credit transfers. Consequently, the current efficiency gaps between domestic and

The ECB has organised a conference in February 2001 to evaluate potential long-term developments in the retail payment infrastructure of the euro area.

cross-border transfers will become even less justifiable.

It is too early to assess whether the progress banks are currently making will be sufficient to achieve substantially enhanced services by 1 January 2002. Banks urgently need to step up their efforts. Throughout 2001, the Eurosystem will monitor the progress made very closely and will continue to assist banks in achieving the common goal. An assessment report on the level of cross-border retail services will be published in early 2002.

This assessment will become a litmus test for retail banking in the euro area. Banks will not have succeeded in an important part of their preparations for the changeover to the single currency if a retail payment infrastructure and service level throughout the euro area, closer to domestic standards,

were not to be achieved in time. A failure of banks to deliver efficient cross-border retail payment services by 2002 would also force the Eurosystem seriously to reconsider its stance and eventually become more operationally involved. The Eurosystem is, however, still confident that banks are

determined and able to deliver substantially improved cross-border retail payment services throughout the euro area by 2002. This should be seen as an important step towards the ultimate objective of a truly uniform “domestic” retail payment area for the euro.