From fragmentation to integration: could the payment systems experience in Europe be useful for Asia?

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Introduction

More than 2,000 years ago, Qin Shi Huang, the first emperor of a unified China, abolished all forms of local currency and introduced a standard national coin. During the Song dynasty, coins from China were exported to Inner Asia, Japan and South-East Asia, where they often became the dominant currency. The Song dynasty was also the first government in the world to issue paper money for general circulation.

Given that China has over 2,000 years’ experience in making payments, I do not think that I am in a position to answer the bold question asked by the title of my speech, namely whether Europe’s payment systems experience could be useful for Asia. However, what I can offer to share with you is a number of lessons that can be drawn from my 20 years’ experience of payment systems integration in Europe. I will then leave it to my Chinese friends to decide whether or not it may be of use to their country.

In this speech, I will start by reminding you of the political context in which the Single Euro Payments Area (SEPA) has come into being. I will then give a brief summary of the characteristics of the European retail payments landscape and the main features of SEPA. Finally, I will discuss the public intervention that will be crucial for the success of SEPA.

Part 1: The history of SEPA

After the end of the Second World War, moves towards bringing the peoples of Europe closer together were seen as the only way to escape from the extremes of
nationalism that had devastated the continent twice in the first half of the 20th century. In this respect, economic integration has proven to be a most efficient way of uniting Europeans. The last few decades of the 20th century witnessed the integration of a number of economic aspects proceed successfully. The objective of a single currency, which was formulated in the late 1960s, became a reality for several countries of continental Europe on 1 January 1999, when the euro was launched as a new currency. In many respects, the euro is today the second most important currency in the world.

The success of the single currency, which allows citizens in the euro area to make cash payments within and across 16 countries as easily as they could using their previous national banknotes and coins, has brought to light the fact that, unfortunately, financial integration in terms of market infrastructures for cashless payments has not progressed at the same pace in each country. In 1990, the year after the fall of the Iron Curtain, the European Commission set out a framework for improving retail payment instruments and making cross-border payments more efficient.¹ The subtitle of that document was “Breaking down the barriers”. However, the private-sector initiative that the European Commission had hoped to stimulate, did not take off because banks claimed that there was a lack of business case. Consequently, with the advent of the euro as a common currency, the European Commission took political action and issued Regulation (EC) No 2560/2001², which stipulated that payment fees should be identical for national and cross-border payments in euro. Banks would therefore have to apply the same prices to national and cross-border payments, despite the fact that cross-border payments are much more costly.

The imbalance between cost-efficient national payments and more costly and less efficient cross-border payments stems from the non-harmonised implementation of technological standards in different countries. In the 1960s, all payments were paper-based. They were submitted manually, transferred manually and settled manually. The automation of payments processing progressed during the 1970s and 1980s, but not in

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¹ “Making Payments in the Internal Market”, COM (90) 447, Commission of the European Communities, Brussels, 26 September 1990.
a harmonised way across countries. Consequently, national payment systems became
cost-efficient, but the retail payment systems that were established were not
interoperable. Cross-border payments therefore still had to be handled and processed
manually, which was not particularly cost-efficient.

With regard to large-value payments and large-value payment systems, in 1999 the
Eurosystem interlinked the existing national real-time gross settlement (RTGS)
systems of the EU countries to create a single system, namely the Trans-European
Automated Real-time Gross settlement Express Transfer (TARGET) system. In 2007,
this decentralised structure was replaced by a single technical platform (TARGET2)
to produce the first market infrastructure to be completely integrated and harmonised
at the European level. With regard to retail payments and retail payment systems,
even the first step of interlinking decentralised national systems could not be achieved
through private-sector initiative. Given the lack of business motivation, it took public
intervention, i.e. Regulation (EC) No 2560/2001, to pave the way for the creation of
the project aimed at reshaping the retail payments landscape in Europe, namely
SEPA.

Unlike with TARGET and TARGET2, the Eurosystem has chosen to treat SEPA not
as a system owner and operator3, but rather as a catalyst, supporting the self-
regulatory market process by using its technical and analytical expertise, as well as its
influence within the banking sector and among other public authorities.

Part 2: The retail payments landscape in Europe and the creation of SEPA

All payments are painful – a simple but universal truth that was aptly expressed by
Lord Byron4 almost 200 years ago. Allow me to add that some payments are more
painful than others: payments can be complex to handle, as well as slow and/or costly.
In a nutshell, SEPA will make payments less painful, especially – but not only –
cross-border payments. Thanks to SEPA, all payments in the euro area will ultimately
become domestic payments, which means that differences between national and

3 However, some central banks that are now part of the Eurosystem have operational roles in the field
of retail payment systems.
4 “Alas! How deeply painful is all payment!”
cross-border payments will disappear. Customers will be able to make payments throughout the whole euro area as efficiently and as safely as in the national context.

SEPA emerged as a private-sector initiative in response to Regulation (EC) No 2560/2001. Banks decided to spearhead this process and established the European Payments Council (EPC) as the decision-making and coordinating body of the European banking industry in relation to payments. The EPC’s members consist of 74 banks and banking associations that represent the banking sectors of 31 countries in Europe.

Aligning the different interests and positions of the various institutions, sectors and countries is no small task. In Europe, there are several thousand banks of varying sizes and types: large banks, medium-sized banks and small banks; banks with global activities, banks that serve the special needs of particular customer segments, regional banks; state-owned banks, savings banks and corporate banks.

Furthermore, retail payment habits differ substantially across countries. In some countries, cash is still king. In others, customers have moved more towards the use of cashless payment instruments. To illustrate these differences, I will give you a snapshot of the use of card payments, as well as credit transfers and direct debits, in the three largest countries of the euro area in 2007:5

<table>
<thead>
<tr>
<th>Country</th>
<th>Payments with cards (per capita in 2007)</th>
<th>Payments via credit transfer and direct debit (per capita in 2007)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>25</td>
<td>147</td>
</tr>
<tr>
<td>France</td>
<td>97</td>
<td>87</td>
</tr>
<tr>
<td>Italy</td>
<td>22</td>
<td>27</td>
</tr>
</tbody>
</table>

Although retail payment habits have already been converging and are expected to converge further, the aim of SEPA is not to promote uniform payment habits. Rather, the aim is to offer a common payments framework to customers in Europe, so that

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5 Source: Statistical Data Warehouse, ECB.
they can use the same set of payment instruments, irrespective of where they are, but still have a choice in terms of which instrument they use.

The EPC has been working towards the **Europeanisation** of the three payment instruments mentioned in the table above: the credit transfer, the direct debit and cards. The **SEPA Credit Transfer (SCT)** was launched more than a year ago and enables payment service providers to offer a harmonised credit transfer service throughout SEPA for single or bulk payments. The **SEPA Direct Debit (SDD)**, which is due to be launched in November 2009, will be the first direct debit instrument that can be used for both the domestic and cross-border collection of taxes or utility payments throughout the 31 SEPA countries. The aim of **SEPA for Cards** is to provide more choice and boost efficiency of card payments in Europe, as well as open up the market to competition.

However, the Eurosystem observes that the cards market is still very fragmented along national borders. Cross-border card transactions are carried out almost exclusively by two international card schemes, namely Visa and Mastercard. Furthermore, the future of national card schemes is uncertain because they are not suited to the European dimension. To avoid a situation where competition becomes reduced to a duopoly of international card schemes, the Eurosystem and the European Commission strongly advocate the creation of at least one European card scheme. A new scheme could enhance competition between card schemes, between card processors and between banks. It could also allow for diversity in card scheme governance and in scheme ownership models. Between the United States, where Visa and Mastercard dominate the market, and Asia, where China Unionpay and JCB have successfully been established, we must be careful that Europe does not become the black hole in the cards universe.

Although cheques are still commonly used in some euro area countries (e.g. France and Ireland), they are not included in the SEPA process because their usage is declining everywhere and, in many countries, they have already almost disappeared.

The **Europeanisation of retail payments** is one side of the SEPA coin. The other, which is equally as important, is the **modernisation of retail payments**. By
modernisation, I do not just mean technology, standardisation and telecommunications. Modernisation is also about transforming existing market structures, both on the supply and the demand side. However, such transformations must take into account market expectations. Some initiatives, such as e-money, have not been entirely successful because they did not meet real customer demand.

The chip, the internet and the mobile phone are three innovations that have had a most profound impact on society over the last 20 years. To be able to satisfy the demand of the mass market, these three things need to be seamlessly integrated into the payment chain, i.e. from payment initiation to payment reconciliation. Mobile payments and mobile banking services, which are currently still being piloted in many countries in Europe, have great potential for development. What is crucial is that innovation takes place in an harmonised way in Europe, in order to avoid the emergence of non-interoperable solutions, as was the case in previous decades. It will also come as no surprise to you if I add that central bankers will also ensure that security concerns are not neglected.

**Part 3: Why the success of SEPA is not yet certain, and what needs to be done**

Will SEPA succeed in making retail payments less painful in Europe? At the moment, there are some grounds for doubt. More than a year after the successful launch of the SCT, SCT transactions constitute only 2.0% of the total credit transfer volume in the euro area. At that rate, the migration could last almost half a century!!!

What anecdotally became known as “mini SEPA”, i.e. the perception that SEPA is nothing more than a solution for cross-border payments, also gives grounds for doubt. Restricting SEPA to cross-border payments will result neither in the Europeanisation nor the modernisation of retail payments in Europe.

In addition, with regard to the SEPA Direct Debit (SDD), there is still a lot at stake. Of course, the decision by the EPC to launch the product in November 2009 is an important step forward that may help to cut the Gordian knot that has hindered progress in SEPA considerably over the last few months. However, we cannot escape the fact that it has been adopted by the EPC with some abstentions and some
opposition. Owing to the strong network effects, such abstentions/opposition may have a negative impact on the actual implementation. Moreover, it remains to be seen whether users will be content with the product. Most of them think that they do not know enough about it.

Last but not least, SEPA for Cards and the need for a European card scheme: the international cards market is characterised by high entry barriers and thus far no clear leader has emerged for such an ambitious and far-reaching project.

After all this doom and gloom, is there no ray of hope on the horizon? Allow me to give you my personal view here. First of all, we should not underestimate what has been achieved so far. The work of the EPC and the banking sector has made good progress and I believe that they are well on their way to fulfilling their mandate. However, there are signs that the limits of self-regulation are now close to being reached. Self-regulation works well in the interbank sphere, but SEPA clearly goes beyond that sphere, as it also requires adjustments in the payment-related activities of users. From my point of view, one precondition for making SEPA a reality is a definitive migration end-date. However, a migration end-date is not something that banks can impose on other stakeholders in the SEPA process; rather it is a public policy issue. The time has therefore come for more public intervention.

Let me elaborate on the need for a publicly determined migration end-date. We all know that financial resources for IT investments are scarce. Thus, there is a high risk that investments in SEPA will be postponed or shunned altogether. Given the financial crisis, this is even more the case today than it was a year ago, when the need for a SEPA migration end-date was first discussed. Additionally, there is a first-mover disadvantage in SEPA investments, as first-movers need to invest more than followers. The notorious chicken-and-egg problem (no demand without appropriate investment in service offering, no investment in service offering without sufficient demand) can only be overcome if a binding migration end-date is set by means of public intervention.

The success of SEPA is now largely in the hands of the political authorities. The European legislator may have to intervene. Moreover, public administrations’
payments in the Member States represent at least a quarter of all payments in Europe. Public administrations could therefore play a critical role in the success of SEPA.

**Conclusion**

Despite the grounds for doubt that I mentioned earlier, and despite the financial crisis that is impacting all areas of banking, the completion of SEPA remains an achievable goal. Banks and public authorities need to make use of the available tools to respond to the difficulties that have emerged. A realistic but ambitious SEPA migration end-date is indispensable.

SEPA is a vision. This vision will come true only if all stakeholders (not only banks, but also users) share that vision and if public authorities are ready to play a more active role.