



EUROPEAN CENTRAL BANK

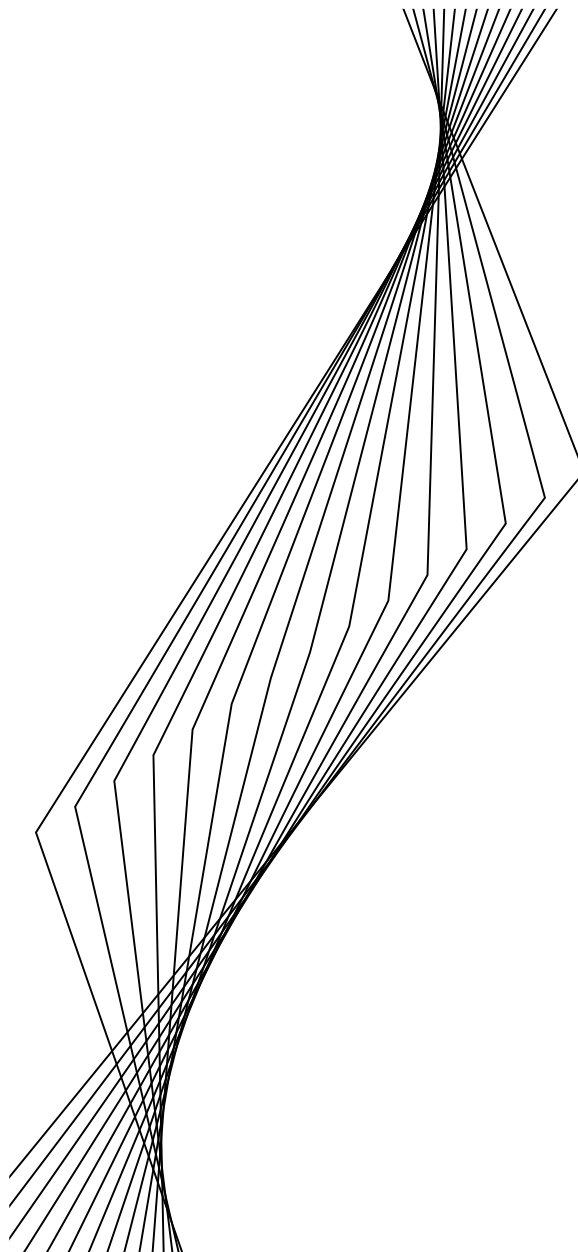


**IMPROVING
CROSS-BORDER RETAIL
PAYMENT SERVICES
THE EUROSISTEM'S VIEW**

September 1999



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Address	Kaiserstrasse 29 D-60311 Frankfurt am Main Germany
Postal address	Postfach 16 03 19 D-60066 Frankfurt am Main Germany
Telephone	+49 69 1344 0
Internet	http://www.ecb.int
Fax	+49 69 1344 6000
Telex	411 144 ecb d

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Introduction and Executive Summary

Efficient and reliable cross-border payment services are essential for the smooth functioning of the Single Market. Citizens and businesses alike can only benefit fully from the principles of the free movement of goods, services, capital and people if they are able to transfer money as rapidly, reliably and cheaply from one part of the European Union to another as is now the case within each Member State.

The introduction of the euro should provide an important contribution to the completion of the Single Market. However, individuals and businesses have, on several occasions, expressed concern that the introduction of the euro has failed to provide the benefits they expected in the area of retail cross-border payments. The prices for retail cross-border payments are still substantially higher than fees for domestic payments, although the introduction of the euro has removed the costs of currency conversion within the euro area. In addition, execution times are substantially longer for cross-border payments than for domestic ones. In the absence of substantial improvements since the start of Stage Three of Economic and Monetary Union (EMU), the acceptance of the euro by the citizens of Europe may be undermined. The difference in service levels will become even more apparent, and therefore problematic, after 2002 when all citizens of the euro area will use the same currency denomination.

Improvements in the practices of banks should result from the implementation, in August 1999, of the European Parliament and Council Directive No. 97/5/EC of 27 January 1997 on cross-border credit transfers, which establishes common rules in the area of transparency and performance of cross-border payments. However, since the Directive applies to the whole of the European Union, its scope is limited to addressing certain specific aspects of cross-border credit transfers within a multi-currency environment. The implementation of the Directive may not be sufficient to respond to the needs and expectations of users of payment services within the single currency area.

The competence of the Eurosystem in the area of payment systems is based mainly on Article 105 (2) of the Treaty establishing the European Community and Article 3.1 of the Statute of the ESCB, which stipulate that one of the basic tasks of the Eurosystem is to "promote the smooth operation of payment systems". These articles do not distinguish between large-value and retail payments, nor between domestic and cross-border ones; therefore, the Eurosystem must be concerned with efficiency issues related to retail cross-border payments.

Inefficiencies in the field of retail cross-border payments are partially linked to the still predominant recourse to correspondent banking and the lack of adequate interbank infrastructures. More efficient fund transfer arrangements have been set up during recent years, but these are too fragmented and economies of scale are very limited.

One precondition, therefore, for realising a substantial enhancement in the processing of retail cross-border payments is undoubtedly that the banking industry must consolidate the interbank infrastructure. However, this is unlikely to be sufficient because the interbank processing leg accounts for only a relatively small part of the overall cost. The banking industry must also improve substantially the internal procedures for processing cross-border payments, as well as the communication leg with the customer. This in turn requires a much more extensive use of standardisation, for which the results already achieved by the European Committee for Banking Standards (ECBS) will be very useful.

In this context, the Eurosystem considered how it could best contribute to the realisation of a single euro payment area which would meet customers' expectations in the field of retail payments. After having discussed several alternatives the Eurosystem took the view that its operational involvement would not, at present, be justified. The Eurosystem is also aware that banks have been addressing this issue recently in a more intensive way and therefore that they should be given the chance to find better arrangements in the coming months.

The Eurosystem intends to become a catalyst for change, initiating regular discussions with the banking and payment service industry in order to facilitate the achievement of euro area agreements which will improve the environment for retail cross-border payments, in particular in the field of standardisation.

To launch the discussion and give a clear signal to the industry and the public, the Eurosystem has defined the following objectives, which it expects the industry to fulfil:

- 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.

These objectives are aimed at inviting the industry to make the investments needed in order to bring the efficiency level of retail cross-border payment systems closer to that of domestic payment systems. These objectives endeavour to strike a balance between what is expected by users, and what the industry can realistically deliver in the short run.

The report is structured as follows: Chapter 1 explains why the current low level of efficiency in the processing of retail cross-border payments is a concern for the Eurosystem; Chapter 2 addresses the causes of the present situation; and Chapter 3 explains the strategy and objectives of the Eurosystem.

1 The low level of efficiency of cross-border payments – a concern for the Eurosystem

1.1 The present situation is not satisfactory

Approximately 100 million domestic retail payments are processed daily in euro area countries, whereas the number of retail cross-border payments is very limited, probably only a few hundred thousand per day, most of which are card payments.

The present situation in the area of retail cross-border payments, especially with regard to cross-border credit transfers, is not satisfactory because:

- prices for cross-border payments are substantially higher than for domestic ones despite the introduction of the euro; and
- the execution time is substantially longer than that for domestic ones.

Taking into account the results of the 1993 and 1994 Commission studies (where the average transfer cost was EUR 24 for a transfer of EUR 100), costs have undoubtedly come down but they still remain unacceptably high in comparison with domestic prices. A study conducted by the Eurosystem in spring 1999 indicates that the fees charged to customers vary from EUR 3.5 to EUR 26 for small amounts, while they can reach EUR 31 and EUR 400 for higher amounts. In addition to these fees, banks in some countries add extra charges (e.g. balance of payments reporting, currency conversion, S.W.I.F.T., postage and other communication charges), which may be substantial compared with the basic fees.

The time needed for cross-border credit transfers was 4.8 working days on average (Commission's study of 1994), but with substantial differences between countries. In addition, over 15% of the transactions took more than a week to be executed. No substantial development has been noted since the study was conducted. Domestic payments are usually executed in one to three days, hence there is a clear gap between the service levels for domestic and cross-border transfers.

1.2 The implementation of the Directive on cross-border credit transfers may not be sufficient

Some important changes in the environment and in the current practices of banks should result from the implementation of Directive No. 97/5/EC of 27 January 1997 on cross-border credit transfers, which lays down rules in the area of the transparency and performance of cross-border payments. The provisions of the Directive apply to cross-border credit transfers in the currencies of the EU Member States and in euro up to the equivalent of EUR 50,000. The EU Member States were due to implement the Directive by 14 August 1999.

However, the Directive has been elaborated in a multi-currency context. On the one hand, the Directive might not fully respond to users' needs and to expectations linked to the introduction of a single currency in the euro area (e.g. the default rule of a time-limit of six business days for end-to-end execution of a cross-border payment is still substantially longer than the time needed for executing domestic payments) and, on the

other hand, it may not envisage fully the technical improvements which may be possible once currency conversion is no longer needed. In addition, the Directive may not reduce transfer costs to a satisfactory degree since it may not be feasible to address issues of infrastructure and standardisation in such a legal instrument, despite the inadequacies in infrastructure and standardisation being a major source of costs.

1.3 The Eurosystem is involved

The Eurosystem's involvement in retail payment systems is generally less pronounced than in large-value payment systems, because of the considerably lower systemic risks involved. Nevertheless all central banks do play a role in this area, ranging from overseeing retail payment systems and providing settlement facilities to extensive operational involvement. In retail payment systems, the central banks' main attention is focused on promoting integrity (i.e. the capacity of payment systems to minimise the financial risks associated with money circulation) and efficiency (i.e. the capacity of payment systems to handle money circulation rapidly, reliably and at a low cost).¹

Article 105 (2) of the Treaty considers the promotion of the smooth operation of payment systems to be one of the four basic tasks of the Eurosystem. Moreover, Article 22 stipulates that "the ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries". Three remarks may be made:

- first, the Statute of the ESCB does not repeat the mandate given to the EMI in respect of cross-border payments since, in the context of a monetary union, conceptual distinctions between domestic and cross-border payments are no longer appropriate;
- second, the Statute does not limit the responsibilities of the Eurosystem to large-value payments, but instead gives a general competence on payment systems to the Eurosystem, which obviously includes retail cross-border payments; and
- third, payment systems cannot be considered to be functioning smoothly (Article 105 (2) of the Treaty), or to be efficient (Article 22 of the Statute) when users still pay high prices for rather poor services.

From the above, it can be concluded that the promotion of the smooth functioning of cross-border retail payment systems is undoubtedly part of the Eurosystem's responsibilities. In this area the ultimate objective is to create a single payment area, as a corollary of a single currency and a single financial market, in which citizens and businesses can make small-value payments across borders as easily and cheaply as they can within their own countries.

¹ *As public authorities central banks are also concerned with public policy objectives like consumer protection and the promotion of free competition. However, in the European context, these objectives are not sufficient to justify the intervention of the Eurosystem because there are other authorities which are specifically in charge of the supervision of these objectives.*

2 The causes of the problem

2.1 The interbank aspect

The interbank processing of payments is one of the sources of costs and inefficiencies incurred in cross-border retail payment systems. Retail cross-border payments are mainly processed via correspondent banking arrangements. The correspondent banking channel is based on bilateral relationships between financial institutions. Typically, part of the processing is carried out manually, with a clear impact on the costs. In addition, a large number of bilateral arrangements are needed to provide adequate geographical coverage. As a result, correspondent banking does not allow banks to provide payment services as efficiently as those offered at the domestic level, where most payments are settled within a few interbank funds transfer systems which are fully automated.

Card payments do not follow this model, but employ centralised network solutions and use more automated channels; they are usually considered to be less problematic than credit transfers or cheque-based processing.

Group arrangements between banks have been developed to process cross-border credit transfers more efficiently than traditional correspondent banking, but have the drawback of being closed "clubs", which do not attract a critical mass of payments.

Pilot projects for linkages between Automated Clearing Houses (ACHs) had been developed in some countries (Belgium, Germany, Italy, the Netherlands and the United Kingdom) in the middle of the 1990s. This was in response to pressure from the European Commission. Although they worked relatively well at the technical level, only a small number of links were implemented and, finally, the projects were stopped because most banks were not prepared to use them, since they preferred to maintain existing business relationships.

EU-wide large-value payment systems processing euro, in particular TARGET and the EBA Euro 1 system, are handling cross-border customer payments, but most of them are of relatively high value: in the first half of 1999 TARGET handled about 5,100 cross-border customer payments per day with an average value of EUR 1.4 million, whereas the EBA Euro 1 processed about 32,800 customer payments per day with an average value of EUR 250,000. These systems are still operating below their full capacity, and an increase in their customer-related traffic can be expected but, in this context, it is more likely to involve commercial payments of a relatively high value. Indeed, these systems, built specifically for the processing of large-value payments, are not likely to provide an adequate solution to the problem of retail cross-border payments because: i) for the banks, the direct and indirect costs of real-time, non-batch processing are probably too high to provide an economical solution for the processing of retail payments, at least in the long term; and ii) the potential number of such payments could be much higher than the maximum capacity of these systems (even according to very conservative assumptions and excluding card payments).

2.2 The intrabank aspect

The intrabank processing of payments is probably the major source of costs and inefficiencies incurred in cross-border retail systems. After all, even if retail cross-border payments were processed via the (relatively expensive) mechanisms set up for large-

value payments, the costs of interbank processing would not exceed EUR 1, a cost which, in most cases, represents less than 20% of the total cost for the customer. Non-standardised and inefficient customer interfaces and a relatively low degree of automation in banks' internal systems and procedures explain a large part of the costs. Even when customers provide their orders electronically, the formats chosen are rarely compatible with the formats used by foreign banks. Moreover, because customers do not always have the relevant data, many cross-border payment orders have to be "rectified" by the banks at great cost.

The lack of standardisation, or, to be more precise, the lack of implementation of existing standards can therefore be considered as a major source of inefficiency in the field of retail cross-border payments. However, the banking sector has been successful in designing standards for cross-border payments. The standards developed by the European Committee for Banking Standards (ECBS) such as the IBAN (international bank account number) and the IPI (international payment instruction) could prove to be very useful in facilitating straight-through processing of retail payments, driving down costs and execution times. With IBAN, banks can continue to use their present bank account numbering and sorting code systems. IBAN enables banks to route cross-border transactions automatically across specific countries and provides an interface with the procedures used for domestic payments. IPI is a standard form for paper-based transfer orders, which can, for instance, be attached to invoices by companies having to collect payments from other EU countries. The form would immediately provide a debtor's bank with the necessary information, in IBAN format, on the collecting firm's banking details. Furthermore, the European Banking Standard and Implementation Guide for Credit Transfers specifies data elements and operational procedures for batched remote cross-border credit transfers, whereas the European Cross-Border Credit Transfer Basic Level covers fully automated credit transfers from the originator's bank to the beneficiary's bank within the ECBS member countries.

However, many banks appear reluctant to adopt quickly these standards as it is relatively costly for them to adapt their internal procedures and systems, given the relatively low number of payments concerned. The implementation of the ECBS standards will provide tangible benefits only when the whole banking industry has implemented the standards (network externalities) and the benefits of standardisation will only be substantial if the banks make efforts to familiarise customers with them.

3. The Eurosystem's strategy and objectives

3.1 Operational involvement of the Eurosystem is not desirable in the present context

As explained in Section 1.3, the promotion of the smooth functioning of payment systems, including retail cross-border payments, is one of the basic tasks of the Eurosystem. But the Statute neither prescribes nor precludes the operational involvement of the Eurosystem in retail cross-border payment systems. On many occasions, the Eurosystem has been asked to become operationally involved in order to deliver retail cross-border payment services superior to those which the banking sector has been able to deliver so far.

Considering how best to fulfil its responsibilities, the Eurosystem has examined several options, including its possible operational involvement.

The degree of operational involvement of the Eurosystem must be consistent with Article 2 of the Statute, which states in particular that the Eurosystem “shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources”. In this framework, the Eurosystem could envisage an operational role in the field of payments if and when the market itself either fails to deliver, or by its very nature cannot deliver the services considered. For example, in the field of large-value payments, the Eurosystem has chosen to be operationally involved in the creation and the functioning of the TARGET system because TARGET provides a service which was deemed necessary for public policy reasons but which the market cannot provide: real-time settlement in central bank money.

In other cases related to the payment or securities settlement infrastructures, central banks have been operationally involved for historical reasons, but they are reluctant to become involved in the creation of new infrastructures, at least until the market demonstrates that it is unable to take care of the underlying public objectives. A comparison between the creation of CREST by the Bank of England, on the one hand, and the establishment of the Continuous Linked Settlement Bank (CLSB) by a consortium of private banks, on the other hand, will illustrate this point: while, in the first case, the private sector had failed to deliver an efficient securities settlement system for the United Kingdom, in the second case, the market has shown its ability to address efficiently the problem of the cross-currency settlement risk, without so far requiring the active operational involvement of the central bank community.

There is little doubt that the present situation with regard to retail cross-border payment services offered by the market has fallen behind the policy objective and, indeed, the reality of European economic and monetary integration. Banks argue that it is because of the lack of a sound business case for retail cross-border payments that the current services are relatively poor and limited in number. However, it is not clear whether it is because there is a lack of a sound business case for them that the solutions proposed by the banks are inefficient, or whether it is because the services offered by the banks are inefficient and expensive that the cross-border traffic is low and the business case limited. If nothing is done, this “vicious circle” may never be broken.

However, there are some indications that the general appreciation of this problem by the private sector is now changing. New initiatives have recently arisen and the Eurosystem considers it too early to evaluate their contribution to the improvement of the cross-border payment services offered by the industry.

The Eurosystem has therefore concluded that its operational involvement does not appear desirable at present. The Eurosystem is convinced that it could best fulfil its responsibilities in acting as a catalyst for change in helping the banking and payment service industry of the euro area to find appropriate solutions.

3.2 The objectives of the Eurosystem

As a starting-point, the Eurosystem has defined a set of objectives which it would like the banking and payment service industry to fulfil. To take up this challenge, the ECB and the national central banks are open to discussion on possible solutions and to co-operation with the industry in order that these objectives may be achieved.

3.2.1 *The Year 2002 objective*

According to the Treaty, the introduction of the single currency will be completed in 2002 when domestic and cross-border retail transactions within the euro area countries will have one denomination only. The tangible benefits of the single currency, in particular for citizens and businesses, will then become totally visible. However, these benefits could be obscured if the existing barriers to low-cost, rapid and secure retail payments are allowed to remain. European citizens may even challenge the benefits of Monetary Union and have their confidence in the single currency undermined if they continue to pay much higher fees for cross-border payments than for domestic ones.

The Eurosystem understands that improvements in the speed and cost of retail cross-border payments represent a very difficult challenge for the banking sector since it entails substantial investments to create new infrastructures, to modify internal procedures within the banks and to educate customers. However, the Eurosystem is convinced that substantial improvements are possible before 2002, even if it remains very unlikely that cross-border payments in euro can reach the same level of efficiency as domestic ones by that time.

3.2.2 *Priority should be given to credit transfers*

The four most widely used cashless payment instruments in the euro area are card-based payments, the cheque, the direct debit and credit transfers.

Card-based payments are already widely used in a cross-border context. Although the cross-border use of cards triggers higher fees than in the domestic context, the difference is not as big as for other instruments. As a result, the fees appear relatively well-accepted by users. Improvements are certainly still possible, in particular in the context of the single currency, but they appear less urgent than for other instruments.

Card schemes have typically been designed for the execution of "face-to-face" payments (i.e. when the payer and the payee meet physically), but they cannot always respond fully to user needs for remote payments (i.e. when the payer and the payee do not meet physically), for which at least one other instrument must be promoted.

Cheques can be used for face-to-face or for remote payments. However, they are very expensive to process, in particular in a cross-border context, and the extent of their use varies substantially across countries (more than 60% of the euro area cheques are issued in France). The use of cheques is steadily declining everywhere, mostly to the benefit of payments by cards which are more convenient for users and cheaper to process for banks. As a result, it does not appear advisable for the Eurosystem to encourage the cross-border use of cheques.

Credit transfers are payment instruments which could be particularly helpful in a cross-border context, because they are very flexible to use in a remote context, in particular when the payer and the payee have a bank account, which is almost always the case in the euro area. Most of the complaints made by users of cross-border payment services relate to the inefficiency and the cost of cross-border credit transfers. The Eurosystem is convinced that it is in this area that banks should currently concentrate their efforts.

Ideally, cross-border payments could also be executed via direct debits. Although domestic direct debit schemes work relatively efficiently, their technical and legal features differ substantially and it will therefore be costly and time-consuming to adapt them for cross-border use. In addition, in contrast with credit transfers, direct debits cannot fulfil all users' needs for remote cross-border payment services because they can be used only for recurring payments.

As a result, because limited time is available before 2002, the Eurosystem is convinced that the banking sector should concentrate its efforts in order to be able to offer to its customers an instrument well-adapted for face-to-face payments, namely the card-based payment instrument, and one well-adapted to remote payments, namely the credit transfer. Because the first of these is already relatively efficient and the second one very inefficient, efforts should be concentrated on credit transfers.

3.2.3 The price of cross-border credit transfers should decrease substantially

The final price of the credit transfers will be determined by banks, acting in a competitive environment. With due recognition of the need for a fair remuneration for the service provided, it should nevertheless be possible to achieve a substantial improvement in the current situation. As a short-term objective, these fees could be significantly reduced by pricing the domestic processing component of cross border transfers at the same level as national ones, insofar as they comply with domestic standards and procedures and, hence, can be processed together with domestic payments. Assuming the volume of cross-border payment business increases substantially over time, prices for retail cross-border credit transfers should approach those of retail domestic credit transfers.

3.2.4 Settlement time should be comparable for domestic and cross-border payments

Retail cross-border credit transfers should be processed as quickly as payments made within the domestic environment. The end-to-end execution of cross-border payment orders should not take more than one day longer than the time needed for domestic payments.

3.2.5 For cross-border credit transfers, as a default rule, fees are to be borne by the originator of the payment only

The Directive on cross-border credit transfers states that customers should be informed in advance of all costs related to transactions. When the sending and the receiving credit institution have a well-established business relationship, it should be possible to meet this requirement. Where this is not the case, and in order to prevent practical problems from arising, only the originator of the payment should be charged with no costs being borne by the beneficiary. This default practice would also be in line with prevailing current practices for domestic credit transfers, thus contributing to the creation of a single euro payment area and to the achievement of full cost transparency, as requested by the Directive.

3.2.6 Access to cross-border retail payment systems should be open

Any solution increasing the efficiency of retail cross-border payments should be accessible to a wide range of institutions. Currently, when correspondent banking is used to execute cross-border payments, many intermediaries may be involved, all of which require some extra time to process the payments as well as face extra costs. By granting

open access to cross-border payment systems, unnecessary intermediaries, and thus additional costs and extended payment execution times, can be avoided.

To avoid unnecessary risks, cross-border retail payment systems may impose access criteria upon prospective members, but to achieve the objective of open access to systems, these access criteria should be public and be applied objectively, fairly and in a non-discriminatory manner.

3.2.7 Existing standards should be implemented as soon as possible

The processing of cross-border retail payments typically involves manual intervention, both at interbank and intrabank level, with a clear negative impact on costs and payment execution times. Customer interfaces are in many cases poor and the banks' internal systems and procedures are not automated to a satisfactory extent. Even when customers provide their payment orders electronically, the formats chosen are rarely compatible with the formats used by the foreign bank.

These problems can be avoided by standardisation, which should be seen as a key element in enhancing the efficiency of payment systems. Since the banking sector has already been successful in designing standards for cross-border payments, these should now be widely implemented. The European Committee for Banking Standards (ECBS) has developed standards, such as those for credit transfers and the international bank account number (IBAN), which could prove very useful in facilitating straight-through processing of retail payments, driving down costs and execution times. The Eurosystem stands ready to play a co-ordinating and supportive role with the aim of facilitating the actual implementation of such standards.

4 Conclusion

The present situation in the area of retail cross-border payments is not satisfactory because prices for cross-border transactions are substantially higher than for domestic ones despite the introduction of the euro, and the execution time needed for cross-border transactions is substantially longer than for domestic ones. This is particularly true of cross-border credit transfers, typically used for remote payments, whereas for card-based transactions, typically used for face-to-face payments, it must be recognised that the banking sector has proved itself able to set up relatively efficient cross-border arrangements.

The main reasons for this deficiency are: i) low volumes by comparison with domestic business; ii) predominant use of correspondent arrangements involving many intermediaries instead of using a single payment infrastructure as is the case domestically; iii) unlike the domestic situation, lack of standardisation and automation at the interbank and intrabank level.

Improvements in the practices of banks should result from the implementation, in August 1999, of the Directive on cross-border credit transfers, which establishes transparency rules for the pricing of cross-border payment transfers and rules regarding the time-limits within which cross-border credit transfers should be executed. Since the Directive

applies to the whole of the European Union, its scope is limited to addressing certain specific aspects of cross-border credit transfers within a multi-currency environment. The requirements of the Directive are far removed from service level practices for domestic payments. Therefore, the implementation of the Directive may not be sufficient to respond to all the needs and expectations of customers with regard to payments within the single currency area. This will become even more apparent in 2002 when the euro is introduced in the daily lives of citizens, who from then on will be able to use euro banknotes and coins.

Based on the Treaty and the Statute of the ESCB, the Eurosystem has a mandate to promote the smooth functioning of retail cross-border payment systems. In order to fulfil this mandate, the Eurosystem is convinced that a single currency environment requires a single payment area. It intends to play a role as a catalyst for change, at present not by direct involvement in the processing of payments, but by discussing with the euro area banking community how best to help it reach this fundamentally important policy objective. In this respect, the Eurosystem envisages becoming more actively involved in the promotion of the implementation of standards, an area in which central banks have been successful at the domestic level.