One for all and all for euro

All 18 euro countries are now part of a standardised payments market. **Edith Rigler** looks at why and how this happened, and what it will mean when the Sepa system is expanded

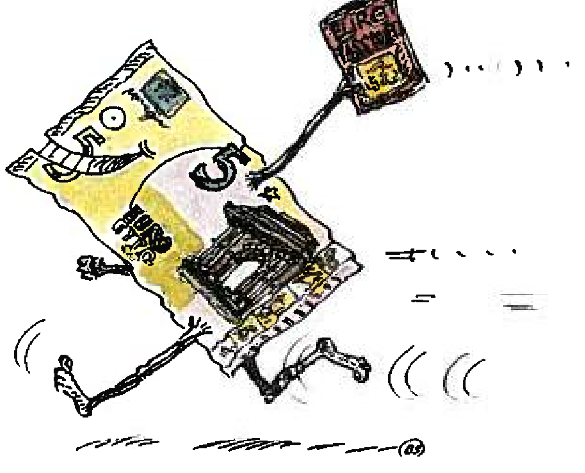
On 1 August, 2014, the European payments market reached an important finish line: Sepa, the Single Euro Payments Area, became reality in all 18 euro countries. New payment rules and formats have standardised the euro payments market. Cross-border euro payments, once hostage to somewhat baroque inter-bank arrangements, can now be processed as efficiently and safely, and at the same price, as domestic euro payments from one single euro bank account. The reduction in transaction costs, and the increased ease in trading across the payments area, should spur competition and foster growth. The benefits promise to be substantial: the Bundesbank estimates that Sepa will bring total cost savings of €123bn over a period of six years.

What does Sepa mean?

Planning for a harmonised euro payments market started in 2002 and it became a reality in August. Sepa is now mandatory in 18 euro countries in Europe. However, another deadline is looming: those countries that are not part of the euro area (eg, the UK, Sweden and Denmark) must adopt Sepa standards by 31 October, 2016. Then all 34 countries of the EU will form a true, single payments market.

Once that is in place, 500m citizens and 20m businesses will be able to use a single euro bank account for all euro credit transfers and direct debits in Europe. Sepa payments are fast, with a transfer taking only one day.

Sepa benefits do come at a price, though. A single payments market means that euro payments must follow defined pan-European standards and rules. Large, medium-sized and small companies,



public authorities and associations are required by EU law to transmit their euro credit transfers and direct debits in Sepa format and must use IBAN (International Bank Account Number) and BIC (Business Identifier Code) rather than national account numbers and bank sort codes. The national formats that existed in each country, and which resulted in a fragmented payments market, can no longer be used. For 4,000 banks and 20m businesses this meant years of work implementing the Sepa rules, which consumed significant resources.

The good news for consumers, apart from the increased convenience, is that nothing changes for them for another 18 months. Consumers can use their "old" account numbers and bank sort code until 1 February, 2016. However, from then on, consumers must use IBAN and BIC as well. Banks have been providing their customers with BIC and IBAN via account statements, and retailers and associations have printed BIC and IBAN on their invoices. So, for the consumer, the change should not be difficult.

A marathon

Like many successful projects, Sepa was a long time in the making. The European Payments Council, the coordination and decision-making body of the European banking industry, started to develop rules and formats for euro credit transfers and euro direct debits in 2002.

Initially, it was expected that the banking industry would achieve migration to Sepa without regulatory intervention. Over the years, however, it became clear that regulation would speed up the process. Sepa Regulation was adopted in 2010, setting a Sepa end date of 1 February, 2014, when all non-Sepa formats would be phased out and only Sepa rules and formats would be legally permissible.

The transition period

Banks, companies and public authorities worked hard to reach the Sepa deadline of 1 February, 2014. But Sepa turned out to be more complex to implement than envisaged and, as a result, migration to its formats was disappointingly slow. A few months before the end date, it became clear that migration to Sepa had not moved at the same speed in all countries: some countries had completed their migration, a second group was making good progress, but a third group was lagging far behind. A harmonised pan-European environment was, therefore, much in doubt.

Not surprisingly, the European Commission concluded that the 1 February Sepa date would be missed by some participants. This would mean that smaller organisations, particularly SMEs and charities, might not be able to make and receive payments in Sepa format, causing them liquidity constraints and payment disruption. That was why a six-month transition period was adopted, during which time banks would still be permitted to accept non-Sepa format from those who were not yet Sepa-compliant. However, 1 August would then be the final finish line. No further extensions were to be allowed.

Not everyone was happy about this transition period. Many were disappointed at what they saw as a sudden change of the rules. Those that were well ahead of others in the race felt let down because the marathon became longer. Some welcomed a "grace period" of six months to allow them to catch up. Some laggards expected the marathon to be cancelled altogether. Central banks recommended keeping the pressure on to reach the original finish line. And some doomsayers even predicted fear, uncertainty and chaos in the markets.

While chaos did not set in, the past few months did create a rather uneven playing field. The transition rules meant that each country could decide for itself whether it would make use of the six-month transition period. Some countries had already fully migrated to Sepa, so the case did not apply to them. Other countries decided to shorten the six months to just three or four months. And some countries left the decision up to their individual banks. In fact, some banks had already closed down their legacy systems so were not able to accept payments in legacy format any longer. In short, February through July 2014 was a difficult environment for banks and their customers alike.

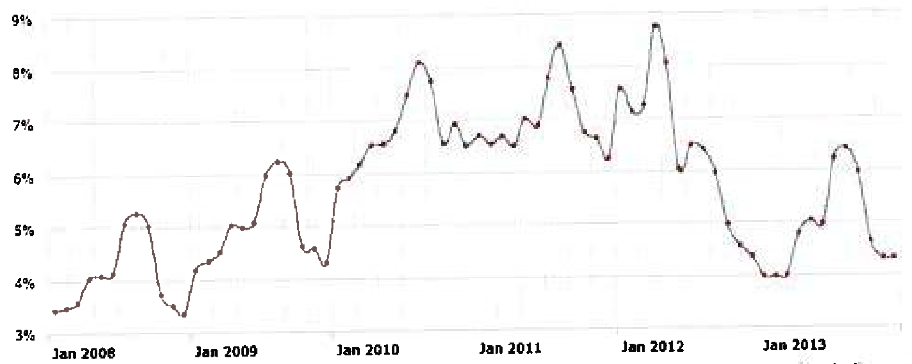
Sepa completed: what now?

Although 18 euro countries have now reached the finish line of the Sepa marathon, the story is not over yet. Sepa remains a work in progress. There are several developments to come:

First, the Sepa area continues to grow: additional countries within the EU are adopting the euro (an example is Lithuania, which will adopt the euro in 2015). But countries outside the EU where euro payments are being used are also interested in adopting Sepa standards to benefit from payments standardisation. Examples are countries with heavy euro flows,such as Montenegro and Turkey.

Second, Sepa exemptions will end.The Sepa Regulation allowed for exemptions from the rules in some countries, relating mostly to the use of IBAN and BIC and the XML message format. By February 2016, these exemptions will be over.

Cross-border card transactions in the euro area (% of total transactions at POS terminals)



Source: ECB SEPA Migration Indicators

Third, non-Sepa instruments will cease to exist: some countries had payment products that did not have an exact Sepa-equivalent. These so-called "niche products" were granted an exemption from the Sepa deadline but must now either be phased out or comply with Sepa rules by 1 February, 2016.

Fourth, a Sepa "fixing, amending and mopping up" exercise is taking place. As with any large, complex project, it became clear during the implementation effort that there were gaps, a lack of clarity and some redundancies and weaknesses in the rules. For example, a new, alternative type of direct debit is being discussed. A consultation period on amendments of the Sepa payments was started and will end soon. This means that much review, consultation, and discussion is taking place. Sepa rulebooks that specify the rules in detail will continue to be amended and, therefore, will be with us for some time.

Beyond these activities, "Sepa Phase 2", which promises further improvements, is now under way:

• Cards have moved into focus. While payments harmonisation has now been mostly achieved, cards, which are the largest electronic retail payment instrument, are not yet harmonised across Europe. Not surprisingly, the ECB has now turned its attention to this. Achieving cards harmonisation is likely to be even more complex than Sepa, because of the large number of stakeholders and providers in the market.

Countries outside the EU are also interested in adopting Sepa standards

• Mobile and "innovative" payments methods are being explored. A newly formed organisation, the Euro Retail Payments Board, replaces the Sepa Council with a broader brief that includes the role of mobile and other "innovative" payments. To that end, it has already set up working groups.

• Sepa's legal foundation is being revised. The Payments Services Directive (PSD), which formed the legal framework for Sepa, has been reviewed. A new revised version, termed "PSD 2", has been proposed. This draft legislative act remains subject to review and is not likely to be adopted before mid-2015. The new directive is aiming to close regulatory gaps while, at the same time, providing more legal clarity and ensuring a consistent application of the legislative framework across the union. Since new market players have emerged over the past few years, and new means of payments have been developed, the directive strives to guarantee both market fairness and a high level of consumer protection.

• Security is a concern that is being addressed. With new payment methods, such as mobile, and the growth of internet usage, the danger of fraudulent activities increases. Recommendations with regard to an increase in internet security have been published at the same time as the PSD 2 proposal could enable third party providers open access to payment account services.

In short, a huge financial integration project has crossed a major finish line. But beyond that finish line, other races have started. There is more work to be done to arrive at a truly harmonised European payments market.

Edith Rigler was global account payables and receivables head at Deutsche Bank in Frankfurt and she started the SEPA program for HSBC in London. Edith wrote a guide on the Payment Services Directive for the Euro Banking Association (EBA). She is now an independent payments consultant.