

Assessing SEPA: Some Implications for Banks in the European Cards Business

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Tanya Martin is a German speaking Senior Consultant in EDC's London office with deep expertise in European payment systems. Joining EDC in 2003, Tanya's focus is in assisting European Banks and Financial Institutions in the review of their payment products and in identifying cost structures within the changing European payments landscape. She has widespread experience in conducting detailed cost studies at both domestic and cross border levels. As part of EDC's team, she has been extensively involved in Interchange analysis within 16 countries. Tanya has produced sustainable results for EDC clients through focused projects in the areas of strategic planning, market entry analysis, profitability improvement as well as financial modeling.

The Single European Payments Area (SEPA) arose out of the Lisbon Agenda, which established the objective to make the EU "the most competitive and dynamic knowledge-driven economy by 2010." The overall objective for the SEPA is to remove all remaining national barriers for payments within the euro area, which will allow for substantial economies of scale as well as provide a customer experience for cross-border transactions similar to the conditions in national markets today¹.

Implementation of SEPA will require cooperation across the payments industry to create the infrastructure and enable the subsequent migration process. This cooperation is required in order to address the growing competitive and profitability issues created by SEPA. Although the criteria for SEPA compliance have not yet been entirely defined, both issuing and acquiring banks, as well as schemes, must comply with the SEPA cards framework (SCF)². SCF will govern the self-regulated introduction of SEPA cards payments, as will the New Legal Framework (NLF) for payments³, which is expected to become law in the EU around January 1, 2008. Consequently, while there are several domestic general-purpose card payment systems within SEPA today, such payment systems that can only be used in one country will no longer be allowed within the post-SEPA environment. In effect, compared to today's fragmented debit cards payment market, the post-SEPA market will consolidate payments through a limited number of schemes and alliances. In addition, there is a requirement to separate brand management from processing.

1. Banks providing card payment services in the SEPA zone
2. Banks which are within the European Union but within countries that do not have the euro currency (for this article we will include the 4 EFTA⁴ countries Iceland, Norway, Switzerland, and Liechtenstein)
3. Banks providing card payment services only in countries outside the European Union

¹ "The Lisbon Agenda – what can banks contribute?" Speech by Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB. IFB seminar "The Future of Payment Systems in Europe", Lisbon, 23 February 2006

² See Press Release 21 September 2005,

http://www.europeanpaymentscouncil.org/documents/EPC175_05_EPC_press_release_Sept05.pdf.

³ See http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0718en01.pdf

⁴ The European Free Trade Association (EFTA) has Iceland, Liechtenstein, Norway and Switzerland as members. EFTA maintains the management of the EFTA Convention (intra-EFTA trade), the EEA Agreement (EFTA-EU relations), and the EFTA free trade agreements (third country relations).

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Manika Aggarwal is a Consultant located in EDC's London office with extensive experience in payment products and services throughout Europe. She joined the firm in 2004 as a graduate after investigating the capital requirements following Basel 2 for the Financial Services Authority. Manika has led the firm's development of a knowledge database dedicated to the Merchant Acquiring and Acquiring Processing business structures across Europe. Working with EDC's domestic and cross-border clients, Manika provides expertise in cost study analysis, market-entry strategies and prepaid products.

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Banks providing card payment services in the SEPA zone

Issuing Banks providing card payment services within the SEPA are facing the heaviest burden to comply with the twin deadlines of launching compliant products by January 1, 2008 and be fully implemented by January 1, 2011. There are significant difficulties in migrating existing domestic debit card schemes into a SEPA environment due to incompatibility of national infrastructures and technology, let alone addressing dispute resolution procedures and charging structures to cardholders and merchants. To overcome these difficulties within a timeline of 18 months issuing banks face a choice of either:

- Undertaking a major investment decision, in order to re-engineer their domestic systems to operate in a SEPA environment and align with a regional provider in the expectation that a SEPA compliant interoperable network can be established, or;
- Alternatively, choosing to migrate their card base to one of the global schemes in the expectation that they will be SEPA compliant (acknowledging that no-one knows for certain what the regulators will define as SEPA compliant).

Faced with this choice many card issuers are considering migrating to internationally branded products (MasterCard or Visa), which provide existing cross border interoperability across Europe and beyond.

Acquiring banks face equally difficult challenges. If new standardized debit payments solutions are to be introduced, as, for example, the EuroAlliance⁵ which proposes to bring together a number of previously domestic processors, acquirers will need to support these payments products. In addition to handling payment card transactions on existing international brands, acquirers will potentially need to support one or more intra-EU SCF compliant schemes.

Along with the technical challenges, profitability of the future payments business within SEPA is a major concern for many banks. Cross-border payments make up a very small proportion of card payment transactions within Europe today. A number of banks and banking associations have expressed the view that the changes required to make domestic debit card payment systems SEPA compliant will be costly to implement, yet will only benefit a small proportion of transactions. As a result, currently efficient domestic payment infrastructures may need to be replaced in order to make them SEPA compliant, with the cost incurred due to a small minority of transactions.

Banks providing card payment services are facing significant financial uncertainty, which comes in addition to the ongoing EMV chip rollout. The financial burden of developing and implementing new or interoperable infrastructures, including exception handling processes and rules are significant. Moreover, the revenue side is uncertain from having to equalise fee structures between domestic and cross-border transactions within the SEPA zone. This, along with significant investment requirements, creates real pressure on profitability. For many banks this may provide an impetus to outsource to third party processors in order to minimize their investment requirements. The recent joint venture between ABN AMRO's merchant acquiring business and First Data to provide joint merchant acquiring and processing services worldwide is case in point of such considerations that others may follow.

⁵ <http://www.zentraler-kreditausschuss.de/upload/1147859674.ZKA-press-finaldoc.pdf>

The single SEPA payments market will remove traditional entry barriers caused by the fragmentation of the payments industry along national boundaries.

However, banks are also concerned about how they can ensure a competitive price from a relatively limited number of service providers. There has been a trend toward consolidation of the processing business with the SEPA, evidenced through recent mergers and acquisitions between processors. Interestingly, a number of bank co-operatively owned domestic processors have been acquired by processors, possibly in part as a result of the previous owners' lack of appetite to commit to the SEPA investment requirements. Existing processors who have acquired such processors have the benefit of being able to standardize on common platforms in due course. However, they do face significant issues of integrating the various businesses as well as supporting a number of non-compatible payment systems in the interim until full SEPA implementation.

Banks providing card payment services in the European Union, but in countries that do not have the euro currency

The European Payments Council (EPC) defines Europe as the EU 25 countries plus the 4 EFTA countries, so although the initial focus of SEPA is on the 12 euro countries the EPC appears to have already targeted the rest of Europe for inclusion at some stage in the future. Governments, regulators and banks individually in countries within Europe, but outside the euro zone, will be strongly encouraged to adopt the SEPA standards and practices as part of achieving the Lisbon Agenda. For some the choice may have been made. For example, the EU accession countries that are expected to join the euro will be required to comply with the SEPA regulations when they convert their currency.

Even for those banks in countries not currently considering adopting the euro, some may find commercial benefits from early participation and integration into the wider SEPA zone and will therefore need to become SEPA compliant for at least part of their operations. For example, Barclays Bank and Swedbank entered into a joint venture to launch the Nordic credit card operator EnterCard. While EnterCard is not required to be SEPA compliant it has the "objective to be the leading credit-card issuer in the Nordic and Baltic region"⁶ and therefore may benefit by seeking early compliance allowing it to compete and bid for business within the Nordic and Baltic countries that are or will become part of SEPA.

Banks providing card payment services only in countries outside the European Union

The establishment of SEPA may impact future strategies of banks operating outside the EU. The single SEPA payments market will remove traditional entry barriers caused by the fragmentation of the payments industry along national boundaries. In the future banks considering a market entry into a country within SEPA will need an infrastructure that will support entry into all other SEPA countries as well. Hence, when considering geographical expansion banks will need to assess whether an investment that would enable it to open up the SEPA region as a whole would be preferable to growing their business on a country-by-country basis outside of the EU.

With much of Europe transitioning to SEPA, it is expected to deliver significant economies of scale. It is anticipated that competitive pressures to achieve economies of scale within SEPA are likely to reduce the number of players in the market. EU regulators⁷ see further consolidation within financial services in Europe as desirable. In a more consolidated market within SEPA international non-European organisations may need to utilise strategic alliances with existing card businesses to achieve more effective market entry.

⁶ Quote from EnterCard website: <http://www.entercard.com/com/front>

⁷ For example see comments on banking mergers in a speech by Neelie Kroes, European Commissioner for Competition Policy: "Tougher competition in retail financial services: a threat or a promise?", Eurofi Conference on Retail Financial Services in Europe, Brussels, 6th June 2006.

<http://europa.eu/rapid/> Reference: SPEECH/06/344 Date: 06/06/2006

The Challenge of Implementation

Introducing SEPA compliant payment schemes will require the definition of operational standards across the SEPA countries. At this stage the international payment schemes appear best positioned to achieve this. Setting domestic standards has been difficult enough for the existing domestic payment schemes - doing the same for a host of payment systems across a number of nations is a daunting task for those cross-scheme task forces who will have to establish and implement them. While SEPA includes some positive principles, there will undoubtedly be challenges to successful implementation.

Interestingly, institutions that have begun to implement strategies to achieve SEPA compliance are in many cases smaller organisations trying to secure their position in the European market. Conversely, amongst larger players, there are some who have not made a clear effort to move toward SEPA compliance. It would appear that a number of countries and institutions have adopted a "wait and see" policy, whereby they expect to be compliant by 2010 but do not see the benefits of focusing on SEPA compliance at this time.

SEPA has been defined to provide incentives to adopt the new standards including the promise of self regulation, if the timeframes are met. However, development and implementation of the required standards and business models appear to have insufficient momentum to meet the 2010 target. This is despite the threat that if the SEPA principles are not met within the agreed timeframes financial penalties and/or tighter regulation could follow. One of the problems is that many of the banks' issuing and acquiring business cases are likely to be impacted adversely by SEPA. EDC has raised this issue with the European Commissioner for the Internal Market and Services, Mr. McCreevy, in response to a presentation he gave on banking regulation and achieving the SEPA vision⁸. EDC has been advised that the Commission recognises the need for banks to generate profits from their payments businesses to ensure a healthy competitive payments market and to enable future investment in payments development and innovation. However, the business case for SEPA compliant card payments is not apparent to banks, which argue that the investments required are disproportionate to the volume of cross-border payments.

From a European perspective SEPA could be seen as raising issues and economic problems counterproductive to the vision of creating a single European economic market outlined in the agenda set in Lisbon in 2000. SEPA was intended to be a cornerstone in the vision "to create the most competitive and dynamic knowledge-based economy capable of sustainable economic growth with greater social cohesion." If, however, the process of euro payments standardisation and commoditisation enables non-European payment providers to gain a significant share of the payment and processing markets, there is a risk of undermining the vision to create a powerful European economic region that can compete effectively in the provision of financial services against other regional economic powerhouses.

While SEPA includes some positive principles, there will undoubtedly be challenges to successful implementation.

The current deadline of January 1st 2011, where no non-compliant payment systems may remain within the SEPA zone, appears to be a challenging target.

Finally, and critically, in spite of the SCF there remain a number of possible interpretations of the requirements regarding harmonisation, implementation and geographical areas. A single definition of SEPA compliance has yet to be established and the differences in interpretations may prove critical to the ability of the payments industry to meet the deadline for full implementation. The current deadline of January 1, 2011, where no non-compliant payment systems may remain within the SEPA zone, appears to be a challenging target. Sincere doubts exist about the ability to meet this deadline and there appears to be pressure on the EU and the EPC for an extension to 2012. The extra time may well be required.

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EDC has been working at both the industry and individual bank level regarding regulatory change and the SEPA reforms. The issues involved are complex and the business planning required to assess future impacts need a broad perspective and long-term view. If you would like more information about how we might assist you to assess the issues involved or incorporate the impacts of card-based payment reforms in your business planning, please contact Peter Sidenius at peter.sidenius@edgardunn.com.

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About Edgar, Dunn & Company

Edgar, Dunn & Company (EDC) is a global strategy consulting firm specializing in financial services. Founded in 1978, the firm is widely regarded as trusted advisors in the payments industry providing a full range of strategy consulting services, expertise and market insight through in-depth industry and consumer benchmarking including its proprietary data intelligence platform, PaymentDynamicsSM. Additional areas of expertise include new financial services channels, technologies and retail financial services.

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