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THE SINGLE EUROPEAN PAYMENTS AREA (SEPA): THE CURRENT PAN-EUROPEAN CHALLENGE

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Abstract: This paper concentrates on the current development of the Single European Payments Area (SEPA), which is envisaged to be in operation by the time Bulgaria accedes to the European Union (EU). For banks and financial institutions in general, this is seen as a tremendous challenge, not only for existing EU members, but also for acceding countries such as Bulgaria and Romania. It will change the entire face of financial markets in Europe, both within and without the Euro-zone.

Key words: SEPA, payments operations, PE-ACHS, clearing systems

Across the whole of Europe and the United States (US), both banks and large corporations are underway with plans and strategies for the planned introduction of SEPA. The European Commission, has delegated the unenviable task of the implementation of this pan-European fiscal concept into reality, to the European Payments Council (EPC). This was done, in order to ensure the introduction of SEPA by 2008, and for it to be fully integrational by 2010. This single market will have a conservatively-estimated volume, of 65 billion payments each year. Currently, no bank today has more than a 3% share of this lucrative market.

The task is so enormous that the European Commission (EC) has set the banks until the end of September 2005 to agree on the methods by which implementation of SEPA will be achieved within the stated time-period, or the EC has threatened to legislate for such implementation arbitrarily.

The underlying problem currently appears to be the harmonization of both legislation and standards throughout Europe. The latter issue will be defined by the New Legal Framework (NLF), which is due to be published by the end of 2005. This will be a significant step forward, as the NLF will clarify the details for all payments instruments to be utilized within SEPA. It

will also provide the legal basis by which internal structural changes can be made, in order for banks and large corporations to define their commercial propositions for their customers.

The aim is, that all customers – whether individual or corporate – should be able to make any payment within the Euro-zone area, both as simply and at the same cost as they currently do in their existing domestic systems. And it is here that one of the major challenges lies: the harmonization and transformation of national payments systems and compliance rules, many of which differ markedly one from another, throughout the Euro-zone members. Apart from this, there is also the fact of cross-border payments and systems which also need to be restructured into one resembling that of a single country – much like the US. The architecture of the completely overhauled and transformed pan-European banking structure, will also require a pan-European Clearing system. For that to happen, either an entirely new Pan-European Automated Clearing House (PE-ACH) will have to be created specifically to handle the various new payment instruments to be introduced, or, the country-specific Clearing Houses will have to interlink their systems, which would

enable them to cover a number of countries.

For banks throughout Europe, the question is primarily one of where they see the role of payments within their business. There are four general approaches to this:

-payments can be seen as “enabling” other services;

-payments can be seen as “driving” other services;

-payments can be seen as being both essential and core to the business;

-payments can be seen as being the basis for further differentiation of services.

Until this basic question is defined and resolved, banks are seemingly currently unable to their commercial propositions for their corporate clients. Therefore, banks which are able to offer constructive corporate propositions - sooner rather than later – will, in all likelihood, win customers from banks which are slower off the mark. Such proposals will inevitably include an enrichment of both their product and service ranges, together with how they intend to represent large-scale payments operations. They will also be forced to make a greater differentiation of their customer bases in order that they can be seen to offer added value.

It is unlikely that every bank will involve itself in the payments aspect of the business, owing to the high cost of pre-SEPA investment requirements and, because of the higher cost of post-SEPA transactions. This will invoke more partnerships between banks. It will also probably ensure that the high level of mergers, take-overs and acquisitions by banks within Europe, will continue to remain at a high level. The larger the bank, the more easily the adjustment to SEPA will be, because large banks have both the scale and the client-base to manage their own payments systems as well as to in-source the payments of smaller banks.

For many banks the evolution of SEPA represents a negative development. The necessary investment in technologies (which for some banks will represent huge amounts) will materially drain their reserves.

This, coupled with the reduction in fees which banks will be able to charge for cross-border, post-SEPA transactions will squeeze the margins of all banks. There will also be the attendant costs of the implementation of this technology. Apart from this, there will have to be a fundamental change in banking philosophy, whereby banks will have to learn to become ‘country-neutral’, and adopt a pan-European perspective.

There are very few banks which have the economies of scale, the structure and the leverage to operate in a ‘zero-margin’ pan-European operation. The largest of these are: ABN-Amro, BNP, Deutsche, JPMorgan, Chase and Citigroup. They will try to win over corporate clients which have pan-European Euro-zone operations. Such a mover, might well be underscored by these banks offering out-sourcing services to smaller banks in order to process their cross-border payment transactions.

Domestic banks will probably, in any case, out-source their cross-border payment transactions, because such transactions form only a very small part of their business. Most of their customer base do not make cross-border payments on a regular basis. This is particularly true of those banks which have concentrated their business activity within the retail banking sector.

All this, will have particular meaning for Bulgaria and Romania. By the time of the political accession of these countries, it is expected that SEPA will be a reality. This means that all Bulgarian banks will have to harmonize both their securities and their payments systems with SEPA. This also means that the infrastructure of both Clearing and settlements systems will have to become fully integrated. The underlying aim in all this harmonization and integration, is, of course, the systemic reduction of risk within the financial sector, while also ensuring that the domestic infrastructures are effective vehicles which ensure fair competition amongst all the enlarged EU and particularly Euro-zone participants. [For

some aspects of this movement in Bulgaria see Stavreva.]

Romania has now developed an integrated payments system which is based on four major aspects:

- A Real Time Gross Settlements system (RTGS);
- An Automated Clearing House (ACH);
- A Government Securities Registration and Settlement system;
- Disaster recovery system.

For Romania, this overall system which became operational in April 2005, will make the Euro-adoption in 2009-2010 a much easier hurdle to overcome, as the system contains within it all the necessary requisites for harmonization with the SEPA. Interestingly enough, the implementation of this system has already reduced the costs of transactions by nearly 25%.

Already, the European banking Association (EBA) has introduced the first pan-European SEPA-compliant Automated Clearing House (PE-ACH) for mass Euro payments. This system deals with the automation of bulk low-value, high-volume inter-Bank payments within the EU. This system is known as the EBA-STEP2 service. In the first six months of 2005, this service received almost 45 million payment instructions amounting to a global volume of almost Euro 100 billion.

Apart from RTGS systems, three other integrated systems are envisaged for those electronic payments which do not require real-time settlement. They are:

- Credeuro (Same-day service);
- Priuro (Credit transfers);
- PEDD (Pan-European Direct Debit).

It is anticipated that these three systems will be in operation from 01 January 2008.

This means that there will be one unique standard for all electronic payments, both for initiation and reconciliation. Put together, this means that all banks, all customers and every international entity in the Euro-zone will all have to migrate towards this single, consistent and integrationally-standard system, which is intended to be fully operational before 2010.

One of the major problems in achieving this, is that each of the financial systems in each of the countries involved, will not be able to move towards SEPA standards in unison. Similarly, systems will have to be in place, which permit parallel processing and interoperability between national and SEPA business practices. Such systems will need to be functional in the fields of:

- format validation;
- credit checks;
- liquidity allocation;
- routing to appropriate payments systems.

In order to accomplish this, banks will need to segment their products by both customer and channel, by separating them into components which are "tightly coupled business activities, supported by human resources, information systems and processes and which are subject to performance measures." [See Nacamuli]

With regard to the emergence of one or more PE-ACHs, movements are afoot, whereby ACHs from within the EU but outside the Euro-zone, are currently developing partnership with ACHs within the Euro-zone. The question which needs to be addressed here, is: How to balance national ACHs with multiple-product ACHs? This is because banks will not want to maintain multiple liquidity pools across a large number of ACHs. Alan Taylor, in charge of the EBA-STEP2 clearing system, sees a 'hub and spoke' arrangement emerging, whereby there will be a few product-specific operations linked into a central 'hub' that will provide a single settlement and control mechanism. Such 'spokes' could be divided into cheques and cards, with direct debits being handled separately. [See interview with Taylor]. Ultimately, with regard to PE-ACHs, it is almost a consensus that current systems are envisaged to operate alongside the development of any new system, and continue to do so in parallel as the new system is developed.

When low-value payment clearing issues are addressed, the two systems already in place i.e. TARGET and EURO 1, it has to be remembered, were engineered and were

devised to handle high-value payments clearing. However, both systems are equally able to handle low-value payments clearing as well. The decision for any bank will probably be determined by cost. Currently, the lowest price for payment clearing in the TARGET system is 80c., whereas the highest pricing for payment clearing in the EURO-1 is 15c.. With the

emergence of TARGET-2 a pricing margin of between 20-60c., is envisaged. Therefore it would appear that the vision of a SEPA heralds the creation of a level playing field within the Euro-zone financial markets. It will increase competition in the banking sector throughout Europe. In the end, it will be the largest and most structural deregulation in the history of financial operations.

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