

# SEPA – from discussion to action

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Europe's diversity is celebrated worldwide. The gastronomic delights of its regional food and drink, and the variations in language and culture are all legendary. But diversity is not so good when it's applied to payments. Having worked to develop a single European currency, the continent is now developing a Single Euro Payments Area (SEPA). This is seen as a fundamental part of the Lisbon Agenda (a commitment that Europe becomes 'the most dynamic and competitive knowledge-based economy in the world by 2010') and recognises that, to compete with major economies, Europe must create a unified domestic economy that makes inter-country trade easier. SEPA rules ensure that, when used within the SEPA area, customers will get the same service at the same price for euro credit transfers, card payments and direct debits irrespective of the country they are based in.

SEPA will have a wide-ranging impact on the payments business, leading to convergence at every level of the industry. The adoption of European-wide standards will facilitate this development, enabling different strands of the business to move closer in terms of timing, pricing and payment type.

## What's It All About?

The SEPA concept originates from the European Commission-led drive, back in the 1990s, to create harmonisation within the EU market. Helen Smith, lead analyst, Cards and Payments, Datamonitor, explains: "The introduction of the euro brought things to a head because, while many EU countries had the same currency, other payment mechanisms weren't so alike. Initially there was a push for cross-border transfers. However, the banks were slow to respond because they didn't want the extra costs involved in implementing mechanisms to facilitate this move. After the European Commission investigated the progress of cross-border transfers and saw that little progress had been made, it introduced regulations, in 2001 [EU Regulation 2560/2001], that said charges at an ATM should be the same regardless of the country the

cardholder was in. This legislation caused problems for banks, so they responded by creating the European Payments Council (EPC)."

The SEPA is a logical move designed to improve competition and transparency. But it's also a bold move, which will impact on the whole European payments market, leading to the probable convergence of wholesale and retail payments.

While increased competition should ultimately benefit corporate and consumer customers alike, banks will have to shoulder much of the financial burden. To compensate for the inevitable revenues lost through regulation, they will have to implement new business processes, something which Gertrude Tumpel-Gugerell, member of the Executive Board of the European Central Bank (ECB), acknowledged last year: "So far, only very rough first estimates exist as to the potential implementation costs of the SEPA. TowerGroup expects that incremental spending by the European banking industry to implement the SEPA on European payment system infrastructures might exceed €8 billion within the next six years. Cap Gemini estimates that price reduction effects might cause an overall decrease in revenue of between €13 billion and €29 billion (minus 30 percent-60 percent, measured against their 2010 baseline scenario without the SEPA)."

However, doing nothing is not an option, a fact picked up by delegates at MasterCard's debit conference in February 2006. As many industry insiders now believe, the SEPA will happen – and if it doesn't occur naturally, regulation will be imposed to ensure that it does.

## Progress So Far

The move towards the SEPA is building momentum. During 2005, the EPC worked to create rules for electronic credit transfer and direct debit, and also defined the single market for cards and cash. In parallel with these developments, the European Commission formally adopted

the EU Payments Directive (known as the New Legal Framework), which defines the conditions under which payment services are offered to end users.

The EU's timetable requires new services to be optionally available from January 2008 and full SEPA implementation to be achieved by 2010. "The timetable is tight," says Helen Smith, Datamonitor. "The critical mass of users should be part of the SEPA by 2010. However, some banks have an issue with 2010 because they want to stay on a domestic system – especially for direct debit — after that date."

**"The SEPA will require a number of reforms," says Jean-Francois Denis, global head of Electronic SEPA Payments, Fortis Bank. "However, it is still unclear how this will affect the banking business. Infrastructure will clearly have to be reformed, and there is a challenge of integrating the right systems. In turn, this will impact back office operations."**

## Opportunities And Challenges

Members of the corporate market are already well ahead on the SEPA road. They stand to benefit most in the short term, thanks to faster processes and lower prices as well as improvements in liquidity management encouraged by competition. However, to enjoy these benefits they must have moved their treasury systems to International Bank Account Numbers (IBANs) and Bank Identifier Codes (BICs).

"Already corporates operating in multiple countries are centralising their accounts and treasury, and the emergence of SEPA will only speed up this process. For instance, it's not cost-effective for corporates to hold several local direct debit schemes," says Jean-Francois Denis, global head of Electronic SEPA Payments, Fortis Bank.

Consumers will also benefit, as Pierfrancesco Gaggi, head of Payment Systems Department, Italian Bankers Association (IBA), comments: "In the short term, this will [for example] provide the best solution to German owners of holiday homes in Greece to pay for services and receive rent on the home from one bank account. Ultimately you could even have an Italian opening a current account in the UK to make payments in Italy." However, Luke Olbrich, vice president, Debit Development, MasterCard, points out: "Although the concept of cross-border banking will be theoretically possible, in the short term you'll probably just see clusters beginning to emerge with certain countries

focusing on language. For example, acquirers in Germany will be doing business in Switzerland and Austria, French acquirers with Belgium, English with Irish, and Benelux countries with each other."

For banks, the picture is more complex. Risks will have to be managed, but there are further challenges, as Jean-Francois Denis, Fortis Bank points out: "The SEPA will require a number of reforms. However, it is still unclear how this will affect the banking business. Infrastructure will clearly have to be reformed, and there is a challenge of integrating the right systems. In turn, this will impact back office operations."

These reforms mean banks will seriously have to examine all costs and revenues associated with payments, as Pierfrancesco Gaggi, IBA comments: "In order to maintain an earnings flow in the face of falling revenue, banks will have to reduce costs. Some banks, handling huge volumes of transactions, could increase their economies of scale by putting together volumes handled in different EU countries, while smaller banks may need to work in a co-operative approach among themselves."

But the SEPA will open up the eurozone completely, enabling banks to offer their services to consumers and companies within Europe irrespective of their geographical location. This opportunity to penetrate more markets with innovative payment products could see banks and non-banks moving further into channels such as ePayments and mobile payments, leading to even greater economies of scale. It could also help push payments away from cash, which currently represents about 79 percent of retail transactions throughout the continent and costs the European economy an estimated €50 billion each year\*.

"Profitability will be enhanced in those countries where there has been zero incentive to market products, because there will be a harmonisation of interchange rates which will alter the economic model for banks. In turn, this will provide an incentive to change," says Luke Olbrich, MasterCard.

The impact of the SEPA will be felt differently depending on the bank. The emergence of pan-European banks is certainly helping drive the SEPA, because these multi-country organisations will benefit from improved efficiency as well as economies of scale. International bank brands will also be able to take advantage of the opportunities of a 'domestic European environment' which will enable them to rapidly

penetrate new markets. Domestic brands will face the most challenges, although it is still unclear how these challenges will be met.

## The Impact on Cards

In September 2005, the ECB introduced the SEPA Card Framework (SCF). This defines the principles for all card transactions within the eurozone and requires the full implementation of EMV chip and PIN security standards in all euro countries by 2010.

The SCF marks a major move away from the numerous national debit schemes that characterise the card payments landscape, such as Mister Cash and Carte Bancaire, which are owned by the national bank schemes and have national standards, constitutions, interchange regimes and processing infrastructures.

**“MasterCard and Visa didn’t make EMV mandatory, so we welcome the SEPA as it will drive the rollout of EMV,” says Luke Olbrich, MasterCard.**

It also means big infrastructure changes for the cards business. “Here, domestic debit schemes may choose to co-brand with international schemes such as Visa and MasterCard,” says Helen Smith, Datamonitor. “Another approach may be to launch reciprocal agreements between the groups of companies that run card processing for domestic programmes. A further approach may be to create a separate SEPA brand that domestic schemes could buy into.”

Germany’s Zentraler Kreditausschuss (ZKA), the working committee of the German banking industry, is already offering its debit card payments system throughout Europe.

However, this must compete with MasterCard and Visa, whose debit schemes (Visa’s V-Pay and MasterCard’s Maestro) are becoming increasingly well known. Traditionally these schemes have been marketed and branded on a country-by-country basis. But in February 2006, MasterCard revealed a marketing platform for the Maestro brand across the SEPA. “This is the first time that MasterCard has coordinated Maestro-brand marketing across countries, and is focused on low value payments, where cards have typically not been used,” says Luke Olbrich, MasterCard.

Visa Europe believes pan-European card systems still need to consider local conditions. According to the company: “To be successful, any payment products need to be extremely sensitive to the level of development within local economies, the prevailing payment

habits of local populations and the circumstances of local retailers. Banks and inter-bank organisations recognise that a single, monolithic governance system could never be sophisticated enough to respond to these local nuances.”

## Standards Reform

The SEPA can be achieved only if there are reforms at every stage of the payments process.

One of the main developments will be changes in standards. The XML-based Interactive Financial eXchange (IFX) protocol for the exchange of financial data and instructions could be encouraged by the SEPA (but is not specifically mandated), to provide interoperability between the card terminal and acquirer domains. This protocol has the advantage of providing a cost-effective data conversation.

EMV and the SEPA could become interdependent, as the SCF mandates the use of EMV to cut cross-border card fraud. “This is a big step forward,” says Luke Olbrich, MasterCard. “MasterCard and Visa didn’t make EMV mandatory, so we welcome the SEPA as it will drive the rollout of EMV.”

The SEPA can also pick up on the EMV standards work already undertaken, as Visa Europe comments: “It is fortunate that the creation of an internal market coincides so closely with the move to EMV-chip technology. Thanks to EMV, Europe’s banks are now uniting around a single card and terminal standard. Indeed, if it were not for EMV, the required harmonisation would have been extremely challenging, if not impossible, to achieve.”

However, Jean-Francois Denis, Fortis Bank says: “The SEPA will inevitably bring standardisation and value-added services. But how pure will the process be? It is still too early to say how differently the standards will be interpreted from country to country. There will be differences in the way standards will be implemented in the customer-to-bank area but it should remain a very pure SEPA implementation in the bank-to-bank area.

## Market Infrastructures

The creation of the SEPA will also have an impact on Automated Clearing Houses (ACHs). According to ACI: “These existing ACHs are being replaced by Pan-European ACHs (PE-ACHs).” This is no small task, given that 36 national and domestic ACHs currently operate across Europe. Unsurprisingly, these ACHs are protective of

their domains and there is still a strong wish to keep certain domestic functions in the national ACHs.

Another development is the European Banking Association's Straight Through Euro Processing (STEP2), which is the first PE-ACH system for bulk payments. This began clearing payments of up to €50,000 per transaction in January 2006. As part of EC Regulation 2560/2001, STEP2 payment instructions must include details of the IBAN and BIC, thereby introducing these codes into the domestic retail banking environment.

In Italy, some major banks have signed an agreement with the Euro Banking Association (EBA) to use the STEP2 platform instead of the domestic Italian ACH. According to Pierfrancesco Gaggi, IBA: "This means about 40 percent of Italy's domestic credit transfers [approximately 100 million transactions each year] will be exchanged on STEP2."

The ECB and national central banks will also drive the launch of the Target 2 pan-European Real Time Gross Settlement (RTGS) – a standardised high-value payment infrastructure being launched at the end of 2007.

## Payment Initiatives

Three new generic payment initiatives are being introduced as a result of the SEPA:

- ▶ Convention on Credit Transfer in Euros, designed for credit transfers falling under Regulation 2560/2001;
- ▶ Prieuro, a priority euro payment element which enables a transfer of funds to take place within four hours on a particular day; and
- ▶ Pan-European Direct Debit (PEDD), a planned new electronic scheme which can be used both for cross-border and national transactions, and can co-exist in parallel with unchanged national schemes during a transitional period.

Paul Styles, business solutions manager, ACI, comments: "As these changes take hold, we'll see a commoditisation of payments, which will encourage banks to ask themselves what role they play in payments and how they can differentiate themselves if everybody is offering similar products."

As the banking industry gears up for the next big milestone in 2008, the EU and the ECB will continue to pile on the pressure. The payments operations of banks throughout the eurozone face real challenges in the coming years, so clear strategies need to be put in place to support the opportunities delivered through the SEPA. However, some questions still need to be answered, as Jean Francois Denis, Fortis Bank, comments: "We need to consider how long non-SEPA products will be maintained and how long local ACHs will survive."

## Conclusion

The obvious outcome of the SEPA is a definite convergence of the payments industry. This will mark a clear change on the current 'silo' situation where electronic payment networks in each EU country have distinct networks, standards and regulations addressing similar functions. A move away from the silo approach is a welcome progression because it will address key areas such as isolated solutions and lack of interoperability between payment products, often stretching from the front office, through the back office, and into the separate payment channels.

Furthermore, the boundaries between customer segments – which for a long time have overlapped – will become even more blurred. The industry has already witnessed corporates using card services for purchasing as well as retail customers originating both Real Time Gross Settlement (RTGS) and ACH payments.

**"What we will see is the amount of a transaction becoming less relevant than whether it is an immediate or batched transaction," comments Jim Woodworth, head of Business Solutions, ACI.**

Domestic and international payments will inevitably converge, as will high and low value payments – which have already moved closer together. Another development will be the importance of time criticality in transactions. "What we will see is the amount of a transaction becoming less relevant than whether it is an immediate or batched transaction," comments Jim Woodworth, head of Business Solutions, ACI. This marks a move from the current situation where virtually identical payments often flow through different silos resulting in a difference in processing because of different channel selection.

# SEPA

The SEPA initiative has the goal of migrating the redundant standards, technologies and rules for the many domestic payments systems to an integrated Europe-wide system. This means it will tackle and eliminate the problems associated with the use of various silos that stand in the way of efficiency for all participants in the European payments environment.

“This won’t be achieved without investment in the technology”, says Jim Woodworth, ACI. “Banks will need to work with suppliers who have

experience across the full spectrum of payment systems in the many geographies and have a good knowledge of the local and international standards for card and banking organisations.”

Discussion has moved forward considerably in the past 12 months. Now is the time for action.

*\* The Cards Working Group of the EPC has estimated that the cost of cash to the European economy currently represents €50 billion.*

## About ACI Worldwide

Every second of every day more financial institutions use ACI software to process high-volume payments than any other equivalent provider. More than 800 customers around the world rely on ACI solutions to manage risk, automate back-office systems and provide application infrastructure services.

With a network of sales and support offices across the Single European Area, ACI is uniquely placed to deliver SEPA-compliant solutions that build on the best European and International standards and best practices. Since 1975, ACI has provided software solutions to the world’s leading financial services companies. We welcome the opportunity to do the same for you.

## ACI Money Transfer System™

ACI Money Transfer System is a global payment processing and risk management system that streamlines high- and low-value payments convergence. It is a multi-bank, multi-branch, multi-currency product that provides continuous processing capabilities to maximise straight-through processing (STP) rates.

The Money Transfer System interfaces to real time gross settlement central banking systems, messaging systems, net settlement systems, clearing houses, internal systems, and numerous third party banking applications. It is a single-source solution for domestic and international payment processing and messaging. It is also SEPA-compliant, supports traditional treasury functions and easily integrates with all other bank systems and departments, providing comprehensive, reliable and secure payment transfers.

## BASE24-eps™

BASE24-eps is an integrated, multi-platform electronic payment processing solution that acquires, routes and authorises financial transactions across multiple channels in real time. BASE24-eps provides a full range of functionality to support payment transactions. It supports the transactions of the future, such as mobile commerce and Internet banking as well as the more traditional branch, ATM and POS transactions.

BASE24-eps is used in the majority of SEPA countries today using national-based card, terminal and security standards. It also supports all the relevant international standards and provides EMV parameter update process management. It also supports a wide range of POS and ATM terminals and is fully conformant with the IFX terminal-acquirer specification.

## ACI Smart Chip Manager™

ACI Smart Chip Manager is a multi-issuer and multi-application smart card management system that manages the complete workflow within a chip card scheme. Smart Chip Manager consists of solutions for chip card issuance and management, application parameter management, card personalisation management, and post-issuance services.

Smart Chip Manager offers a complete chip card issuance solution — from single-application EMV cards to multi-application chip cards. Acting as the central repository for EMV parameter values, it retains application, personalisation and parameter data for future real time updates or card re-issuance.

# SEPA

## **ACI Proactive Risk Manager™**

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ACI Proactive Risk Manager is a comprehensive fraud detection solution for monitoring risk in near real time or real time across an institution's business lines and customer accounts. From strategic user-defined rules to powerful neural network technology and automated case management, Proactive Risk Manager provides the means to cost-effectively reduce losses and limit risk exposure.

A comprehensive case management workflow engine enables supervisors to manage investigations and cases to maintain the highest levels of operational efficiency, thus reducing costs. Proactive Risk Manager also captures and maintains statistics to provide valuable management information.

## **ACI Payments Manager™**

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ACI Payments Manager is a modular software solution that automates the processing and settlement of electronic payment transactions. The solution accesses a central database that can be updated in near real-time with transactions from online payment engines. An integrated graphical presentation and development tool is used to access all functions.

The core modules of ACI Payments Manager are designed to streamline and automate daily settlement processes and card issue functions. These functions include fee processing and funds movement, customer and card instrument management. All services are built around a relational database that enhances information management and customer service.

In the SEPA, banks and processors will compete aggressively for the right to process card transactions. ACI Payments Manager is ideally positioned to help financial institutions take advantage of the new fee structures and business rules of SEPA-compliant card schemes and new processing relationships.