

# FROM COMPLIANCE TO BUSINESS BENEFIT

## Country Review

We have reviewed those countries in the European Union with the highest GDP in Europe – France, Germany and the UK – in order to assess how SEPA will affect their financial services industries. The choice of country is based on:

- > The different models for automated clearing that are currently being used. The polar extremes of the models are the national scheme as operated in France and the bilateral schemes which operate in Germany
- > Countries which demonstrate the differences between pure clearing services and other related service offerings.

This chart shows where we believe that SEPA will ultimately push the PE-ACHs that result from the new regulations. Clearing will be centralised and the resulting PE-ACHs will provide clearing and a degree of related services.

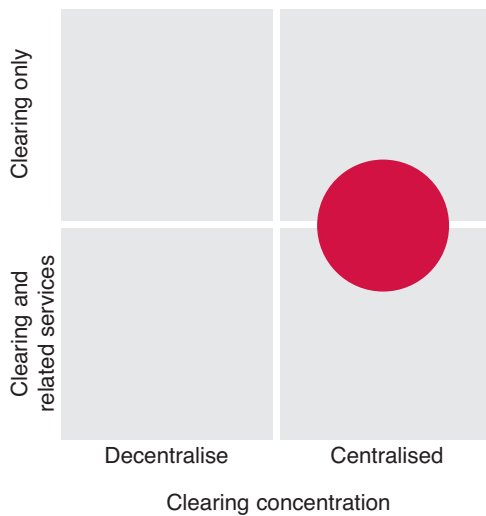
## France

In France, SEPA will be the catalyst for change needed to redevelop the national ACH. At present the ACH role in France is relatively 'thin', with processing closely related to clearing only. This contrasts with a 'thick' service in a country like The Netherlands, where services include:

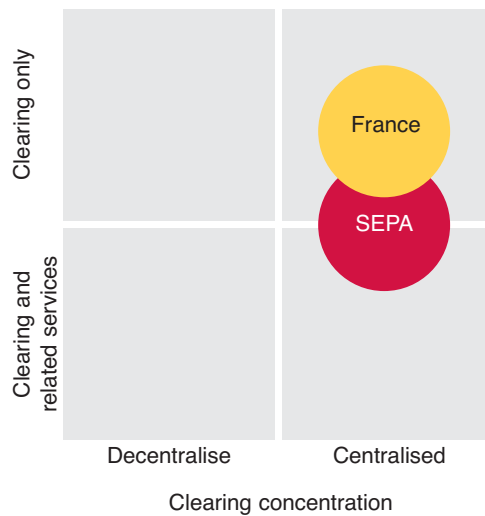
- > Conversion of traditional media (e.g. paper) to electronic files
- > Checking of payment data against a positive file of all domestic account numbers
- > Enabling direct corporate access.

French banks have welcomed the idea of a new ACH that has aspirations to become one of the PE-ACHs in the Euro zone. The move to SEPA is important because it is an integral part of developing the French ACH, but it does not represent a profound change.

### SEPA



### SEPA CLEARING MODEL - France



The loss in payments income for the French banking industry represents a genuine threat. In France, the cards payments industry derives most of its revenue from the card holder rather than the merchant. However, the dynamics of the interchange fee structure between banks could well change. If you also

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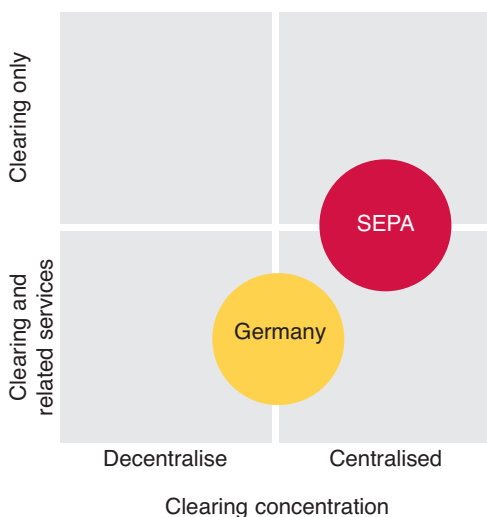
factor in the potential for new entrants to the market, such as telecoms providers and retailers, the profits French banks make from payments are likely to be significantly reduced. Of the three countries we are reviewing, the introduction of non-traditional competition into the payments markets is likely to have the most dramatic effect in France.

A large part of the domestic market segment in France will be driven by payment simplicity and cost. Generally, personal customers use electronic transfers less than in other countries. Moreover, the proportion of card revenue derived from merchants is relatively high compared to the revenue derived from personal card holders.

French card issuers are faced with a clear problem, because a post-SEPA Euro zone presents a competitive landscape that favours corporates.

French banks have realised that they need a defensive strategy. They will have to streamline their opportunities in order to compensate for the loss of payments revenue and to defend their position against new competition in their domestic market.

## SEPA CLEARING MODEL - Germany



## Germany

Germany is the second largest market for financial services in Europe and the biggest in the Euro zone. It is also a leading advocate of the SEPA approach. However, given the fact that Germany has an efficient domestic clearing system, commitment to SEPA is not without question. In June 2006, the German Government discussed the issue. They concluded that while SEPA is an initiative they will support, they see no rationale to stop using efficient and proven methods of local payment after 2010.

Not surprisingly, their statement was welcomed by the various banking lobbies, who agreed that it was not worth changing an efficient payment system to accommodate 2% of cross-border transactions. How the cost of implementing SEPA can be justified by a mere 2% of the payment volume has yet to be explained.

Germany is typical of a key Euro zone country in that it still has to make major decisions about the future of its payment industry. The move to the SEPA model represents a more profound change here than it does in France, as shown opposite.

Will EPC direct debits replace the equivalent German instrument "Einzugsermächtigungsverfahren". Also in this case, IBAN and BIC can be used to identify and debit the bank accounts of individuals.

In the summer of 2006, the XML-data format was defined for IBAN and BIC payment (ISO 20022). Given that many German corporates use the domestic direct debit format, significant effort will be needed for these companies to become SEPA-compliant if the national scheme is abandoned.

Although few credit cards are based on EMV at present, everything seems to be settled for credit card usage. All credit card issuers have chosen the two large international card schemes, Visa and Mastercard, for their products. Visa and Mastercard both claim they will be SEPA-compliant in 2007. However, credit card payment is worth less than 20% of debit card volumes.



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For debit cards, the bank-authorized "electronic cash" system is essential for the German market. With an interchange fee of only 0,3%, it is an inexpensive way for merchants to accept cards for low value transactions. Normally, it is co-branded with Maestro for international usage. Alternatively, German merchants use the information on the card (e.g. the account number) to initiate direct debits. This payment method is known as ELV (electronic direct debit). With no payment guarantee the method is cheap for merchants. But changes to the direct debit scheme may endanger the continuation of ELV. It should also be pointed out that ELV usage seems set to decline in favour of electronic cash, because of the increasing number of refusals.

All bank issuers will have to make decisions about the issuing of debit cards via iV-pay, Maestro, German electronic cash, or a combination of the three. Most banks appear to favour a hybrid solution, with either Maestro or iV-pay in combination with electronic cash. While it would be easier to take the Maestro/iV-pay route, some banks feel they have less influence over the standards and operations of what they see as 'American' systems. Therefore the ZKA defined changes to internationalise the electronic cash system. On this basis ZKA is talking to other EU countries to "export" the electronic cash system in order to make it SEPA-compliant. Additionally ZKA is a driving force of EAPS (Euro Alliance of Payment Schemes), which has been assembled to promote co-operation between existing European debit card payment schemes.

Hence, the current German debit card will migrate to become a SEPA-compliant instrument. Instead of the national magnetic stripe track 3, the international track 2 will be used for electronic cash only from 2008 and the chip application electronic cash will have been completely merged to EMV by 2011.

German direct debit and cash transfer instruments will be harmonised for use in the Euro zone; the business case that banks present will need to show the economic arguments in favour of maintaining two systems or using only one.

To stay in the market, processors will have to adapt their systems to the SEPA format for remittances, direct debit and cards. International processors, like Atos Worldline, will be in the position to route transactions within the EU "on-us" without going through the ICS's network. This should allow them to give their customers a price advantage.

An important challenge that remains unresolved in Germany centres upon the timescales for implementing SEPA:

- > As the Payments Services Directive (PSD) will not pass the European Parliament until December 2006 at the earliest there will be a very tight deadline for implementing these requirements by legislation and banking supervisory governance, as well as by payment stakeholders.
- > Following that, all operational changes have to be implemented by 1st January 2008, which is a very aggressive timescale for some institutions.

### United Kingdom

Given that the UK is a 'near - SEPA' country and not in the Euro zone, why look at the impact of SEPA?

Firstly, the UK payments system will not be directly impacted by any of the players providing PE-ACH, or other SEPA-compatible products. The existing infrastructure will have to remain as long as the UK stays out of the Euro zone. However, we will see the UK ACH move towards a SEPA model in the following way:

- > The current faster payments initiative (which will move the UK ACH from a 3-day cycle to a same/next day cycle)
- > The impact of the NLF, which will put the UK on the same legal footing as the rest of the Euro zone.

The technology refresh from the Faster Payments initiative will also enable UK banks to be more competitive and thus better placed for SEPA opportunities.

The UK clearing provider, VOCA, whilst focused on the faster clearing requirement, is also expanding its range of services and intends to offer SEPA services. VOCA may however find that the PE-ACHs which are created represent a threat to its domestic market as they seek to gain scale. This arises because the centralized approach, which is the basis for the SEPA model, is also used in the UK. To counter this threat, £ to remittance services are planned, thus supporting UK corporates and banks in their payments.

UK banks are evaluating the impact of faster payments and SEPA by reviewing their payments business model and strategic approach to SEPA services. While many UK banks have operations in Europe – which has an impact upon their approach to SEPA - all UK banks need to consider whether to offer full SEPA services in-house or to outsource (elements of) their products and services.

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The UK corporates reaction to SEPA will be fairly muted when compared to their European counterparts. Nevertheless, there will be an expectation of easy access to SEPA clearing to reduce the number of cross-border (£ to Euro) transactions. For those corporates who have operations in Europe, there are real opportunities to centralize their payments and accounts. Multi national corporates are starting to show an interest in terms of the impact to their European operations. The UK is a member of EACT (European Association of Corporate Treasurers) which has recently issued a critical response to the SEPA rulebooks. It is therefore essential that corporates continue to help shape SEPA.

SEPA will have little impact upon UK card schemes. There will be a need to ensure any card schemes in SEPA that become SEPA-compliant via ICS (International Card Schemes) are catered for. If a new SEPA card scheme emerges, there may be a business case to allow international transactions, and processors may want to ensure they have the capability for that. However, UK card companies with business in Europe should consider their business as a whole. For example, do they implement a single platform, then consider migrating all UK transactions to this new platform? Consumers in the UK may feel the impact through increased charges for transaction costs. This will result if the banks are unable to continue to subsidise consumer card payments through their corporate payments business because of a more competitive landscape.

With the removal of national boundaries and easier access to cross-border payments products, UK-based banks will have an opportunity to exploit the Euro zone and grow their revenues by acquiring more personal customers and corporate accounts.

In conclusion, UK-based banks and card companies need to carefully consider their strategic business and investment decisions if they are to understand the SEPA payments environment and what it means to their whole business.

