THE EU'S PAYMENTS PARADOX

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THE BREXIT PAPERS

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PAYMENTS in the EU has been fertile territory for EU intervention, in the form of a constant flow of Regulations, Directives and Commission Delegated Regulations.

The EU's record has been an almost unmitigated disaster, destroying the economic basis of the business in pursuit of its abstract, theoretical objectives. Completely undeterred by its own track record, its volume of legislation is increasing. The payments market is a prime example of the oxymoron of the EU: extensive legislation to create a free market, based on false premises.

Terrorist financing – facilitated by loopholes in EU legislation

A current and perfect example of the incoherence of the legislative approach is in the enablement of poorly-documented new arrivals in the EU, possibly terrorists, to obtain bank accounts, bypassing the normal, stringent checks required of banks to open accounts for customers. Then, under the legislation for the Single Euro Payments Area, these people can move money between one another electronically and using mainstream payment methods, without these payments falling foul of checks aimed at 'Countering the Financing of Terrorism'.

This is enabled by the interplay of several EU legislative actions:

1. On Single Euro Payments Area, establishing the International Bank Account Number (IBAN) as the unique identifier of bank accounts within the EU;
2. The SEPA Migration End Date Regulation 260 of 2012 mandates that banks allow customers to only state IBAN for themselves and the beneficiaries of their payments in Euro within the EU, and that

only IBAN is sent down the payment chain to identify remitter and beneficiary;
3. IBAN is up to 35 characters long, and consists of alphanumeric characters: the names and addresses of remitter and beneficiary do not appear. As a result there is no data in the IBAN that can be subjected to filtering against the lists issued by the authorities for ongoing checks for Anti-Money Laundering and Countering the Financing of Terrorism ("AML/CFT");
4. EU Directive 92 of 2014, known as the Basic Bank Account Directive, compels the majority of banks in each Member State to offer bank accounts to anyone who is legally in their Member State and who does not already have a bank account;
5. The definition of "legally resident in the Union" means "where a natural person has the right to reside in a Member State by virtue of Union or national law, including consumers with no fixed address and persons seeking asylum under the Geneva Convention of 28 July 1951 Relating to the Status of Refugees, the Protocol thereto of 31 January 1967 and other relevant international treaties";
6. Normally a bank has to go through stringent Know-Your-Customer checks for AML/CFT but these are waived away in the Preamble paragraph 34: "where a natural person has the right to reside in a Member State by virtue of" the same legal instruments.

So we have a scenario where two persons are admitted to the EU by one of the Member States with minimal or no admission checks. They receive basic papers stating they are legally resident in the EU, and have a right to a basic bank account, and they open them, with the normal Customer Due Diligence checks waived.

Then these people turn out to be terrorists. They can send SEPA Credit Transfers to one another using the mainstream SEPA Scheme, identifying one another with IBAN only. The payment messages need contain no remittance information about the reason for the payment. There is nothing in the payment message to filter against for AML/CFT, the assumption being that, if the remitter and beneficiary have an account in the EU, their own banks have done upfront and ongoing AML/CFT checks and the payments must therefore be clean.

434 million EU adult citizens and millions of EU businesses have to go through AML/CFT checks not just for banking, but with accountants,

lawyers, estate agents, landlords and so on – all at the behest of the EU and under their four Anti-Money Laundering Directives.

But for a sub-group of persons this is all waived, a sub-group much more likely than the median to contain terrorists.

Aberrations in the pipeline

This is the most serious, current aberration, but by no means unique. Two others in the pipeline at present would be:

- The Regulatory Technical Standards (i.e. "RTS" or procedures) being dictated by the European Banking Authority under a Commission Delegated Regulation, for security between a bank and payment companies that offer services related to payment accounts without being banks themselves: the EU is trying to foster this new kind of "overlay service" but industry experts have commented on the EBA's proposed RTS that they will "set the cards and mobile industry back ten years"; and,
- The Interchange Fee Regulation 751 of 2015, cutting the fees that are exchanged between acquirers and banks on card transactions, and thus making it likely that consumers will have to pay to have a credit card, and possibly even to have a debit card, or revert to using cash and cheques – while at the same time the EU professes itself dedicated to supporting the digital economy.

The theme is the always same: legislation aimed at fostering a certain development, taking years to come through, at best irrelevant when implemented, but frequently intrusive at a very detailed level in the marketplace and creating barriers and distortions.

History and rationale for EU interventions

EU has been legislating on the payments market since shortly after the introduction of the euro, with various objectives set:

- Reduce the cost of payments from an assumed 2-3% of EU GDP in 2003 to the assumed Best Practice level of 1% of GDP, taken to be the cost of payments in the USA;

- Underpin the euro and the EU Single Market;
- Encourage greater cross-border trade within the Single Market;
- Convert the payments market into a single EU wide market, as compared to the status quo ante: 28 national markets and a fragmented cross-border market;
- Create a market structure in which there is "market space" for innovation, new entrants, substitutes, increased competition, so as to…
- Foster the digital economy, enable new services and reduce prices.

The main plank has been the creation of SEPA - the Single Euro Payments Area - imposing a set of new payment products for Euro payments (i) at a national level within any Eurozone country and (ii) cross-border between two "SEPA Area" countries, but there are many other legislative elements:

- Regulations to harmonise the cost of a cross-border basic payment in Euro with the cost of a domestic one (2560 of 2001 and 924 of 2009);
- Regulations to specify the information on the remitter and the beneficiary that must accompany a payment (latterly 847 of 2015);
- The Payment Services Directives to harmonise the transparency of the costs of payments, to reduce these costs and to enable new types of competitor;
- A Directive to enable all natural persons who have the right to be in the EU at all to have a Basic Bank Account – 92 of 2014;
- A Regulation to cap interchange fees on card payments;
- A Regulation to eliminate interchange fees payable by the bank that acts for the originator of a Direct Debit to the bank that acts for the payer (the UK direct debit scheme has never had such fees, but several Continental European ones did); and,
- Directives for the purposes of Anti-Money Laundering and Countering the Financing of Terrorism.

Rationale for SEPA

The rationale for SEPA is harmonisation, and indeed the status quo at the time the Euro was launched on 1.1.1999 was not at all harmonised:

- Cross-border payments could take several days, frequently had large fees deducted from the principal amount, rarely carried comprehensive information about what the payment was for, and could be subject to onerous reports to be filed with central banks; and,

- National payments were transacted according to each country's own scheme, in which all elements were specific to the country: roles and responsibilities of the bank/customer/clearing system, message flow, data format in which messages were written, communications networks used, data security methodology, and message content to show what the payment was for.

The EU misinterpreted the status quo and encapsulated the main business case for legislation as being a reduction in cost, without recognising that the national payments markets were efficient but at a low scale, and that their main problem was diversity, not inefficiency.

Misplaced comparison with the USA

Instead the EU, in 2002, landed on a supposed Best Practice 1%-of-GDP cost of payments as being the USA – mainly because it was large and supposedly had scale economies:

- EU cross-border payments frequently cost more than 2-3% of their value – but they only made up 2% of total EU payments;
- EU national payments cost below 1% where cheques were in infrequent use (Belgium, Germany, Finland, Netherlands) and where there was an efficient, nationwide clearing system; and,
- The USA was wholly inefficient by comparison: at the time 50% of all payments were made by cheque. These were frequently posted through a mail system whose delivery times ranged between 1 and 5 days, and then deposited into a clearing system where the time between deposit and settlement was between 0 and 4 days.

Thus, only a person who had no knowledge of US payments at the time could have stated that EU payments cost 1-2% *more* of GDP than US payments – *it was the other way around.*

The EU's determination of this misunderstood problem led to a call for the Single Euro Payments Area ("SEPA") such that:

- Total cost was to be greatly reduced;
- All market participants should be able to use just one account in Euro to make and receive all their payments in Euro with it;

- The terms and conditions between national payments and cross-border payments were to be harmonised, and correlate to the timing and pricing methodology of a national payment; and,
- No market participant was to lose out on feature, function or information.

The medicine of SEPA: completely new payment schemes

The medicine was that two SEPA payment schemes should be introduced and replace all of the predecessor national payment schemes:

- SEPA Credit Transfer (like a UK BACS payment or a Faster Payment)
- SEPA Direct Debit (like a UK BACS Direct Debit)

In parallel – and initially through the 2007 Payment Services Directive – virtually all the practices that gave banks an income on payments were eliminated:

1. Debiting a payment on D but with the value-date of the debit set at D-1, so that the sender's bank gets a day of float;
2. Receiving a payment for a beneficiary on D but only crediting it on D+1, so the beneficiary's bank gets a day of float;
3. Banks taking a slice of the payment as a fee, so EUR100 leaves but only EUR75 arrives; and,
4. Banks acting in the payment chain pass fees back up to the sender's bank, so the sender pays one lot of fees when the payment is sent, and another lot a few days later.

Now the sender is charged a fee by their bank at the time of sending, and the beneficiary is charged a fee at the time of receiving, and there can be a maximum of one business day between sending and receiving. These terms and conditions are the ones that the EU equates to a "basic payment".

Having required, since 2002, some 14 years to achieve that process by 2016, the EU immediately recognised that the digital economy now needs an "instant retail payment", so the ECB created an "Instant Retail Payments Board" and the banks are working on a scheme for instant Euro payments, to be live in 2017. With that, all the investments expended to create the SEPA Credit Transfer on the basis of D+1 have to be ascribed a payback period of three or four years, instead of eight or nine.

At the same time the Interchange Fee Regulation is being introduced to cap card interchange fees to 0.2% for debit card payments and 0.3% for credit card payments, and in banking as a whole interest rates are zero or lower thanks to the policies of Central Banks. Furthermore, banks have to hold more capital against their book of loans under Bank Capital Adequacy rules, and banks have to set aside a meaningful portion of customer deposits into accounts or bonds which have a zero or negative yield – under Bank Liquidity Adequacy rules.

Ruined market economics for incumbent banks – and no case for new entrants to invest

No-one sheds a tear for banks, but this is now a market in which it is impossible for banks to:

- Cover the costs of offering basic banking services in the traditional way: not paying interest on customer account balances and reinvesting the balances for a 3-4% turn, under "normal" market conditions;
- Increase the "free balances" via value-dating adjustments on payments credited and debited to customers, or by money in transit being in the bank's hands for more than one day;
- Make fee revenue from interchange fees on cards and direct debits; and,
- Justify the investments required by EU interventions.

By the same token, if these are the characteristics of the market for the incumbents, why should it be an attractive market to invest in for new entrants?

Yet this is exactly the market that the EU thinks it is creating, not least in its Payment Services Directives that are meant to enable new types of competitor and in turn new payment services, innovation, and more downward pressure on prices:

- A "Payment Institution" or PI
- A "Third-Party Provider" or TPP

Payments is just one of the areas upon which the EU has progressively focused, to impose its version of a well-functioning free market.

Such a market can be construed as a layered market, and in its simplest conceptual form there are just two layers:

Value-Added Layer	The layer in which market actors operate towards users so as to attract them based on feature, function, price: this is the competitive layer and is in principle where the customer pays
Basic Layer	Market actors collaborate in this layer to establish the basic level of services and of the interactions between market actors that make a market possible – such as, in mobile telephony, that any handset can be used in conjunction with any network provider to phone any landline or mobile phone anywhere, regardless of the handset or network used by the call recipient. Services in this layer should be either invisible to the customer or else be free-to-use

The EU's legislative actions have, in its eyes, been conducted – and continue to be conducted – entirely within the Basic Layer, in order to create the necessary preconditions to allow a Value-Added Layer to emerge.

The market model most closely followed is indeed that of mobile telephony, but the analogy most commonly drawn is that of railways: the "Basic Layer" is the tracks, and the "Value-Added Layer" is the trains that run on them and which the customers use and pay for that privilege.

Actual impact of EU interventions to impose the Layered Model

The impact has, however, been as follows:

- The EU has defined the Basic Layer in such detail that no Value-Added Layer has so far emerged: the EU has not just defined the tracks, it has intervened to define the signalling, stations, catering, ticketing…
- Where all services are thus in the Basic Layer and the service has been defined to a fine level of detail by the authorities, there is no differentiation on feature or function, and the only differentiator is price: *a race to the bottom on price*;

- All corporate market actors (that means businesses, public authorities, banks) have had to invest to change their payment processes in order to solve a problem that did not exist for many of them i.e. the ones that only traded domestically and used the efficient, national payment means which met their needs perfectly;
- For them the pan-European "Basic Layer" does for them exactly what the national "Basic Layer" already did – and they have had to pay for the privilege of taking the new one and migrating off the old one;
- Indeed it was not even that good: national markets in several cases found that important functions were absent in the SEPA "core & basic" schemes and had to be rebuilt: this was permissible under the heading in the SEPA Schemes of "Additional Optional Services" or AOS;
- In Italy, for example, the AOS created to preserve the customer experience of the RID – the retail direct debit – has been so extensive as to render the result unrecognisable as anything to do with SEPA;
- In fact AOS has been used as a cover under which to rebuild national-only features and re-establish differences between predecessor markets, frustrating the achievement of SEPA;
- The economics of the Basic Level have been destroyed for the incumbent players – but new players like TPPs can establish themselves and interact with the incumbent players without any entry fee. Indeed, under Payment Services Directive 2, it is the incumbent players who have to invest in order to create "Access to Accounts" or XS2A for the benefit of the TPPs: *the man sentenced to death is forced to pay for his own coffin;*
- At the same time as the EU introduces these new categories of players and accords them market entry, it does not ensure their ability to trade:
    - Payment Institutions generally do not qualify for direct membership of clearing systems, and EU legislation on incumbent banks in the area of Anti-Money Laundering and Countering the Financing of Terrorism has proved a major deterrent to incumbent banks even opening a bank account for them; and,
    - Payment Services Directive 2 requires that the European Banking Authority issue so-called "Regulatory Technical Standards" for the security of the interactions between TPPs and the incumbent banks (who are known by the term ASPSP or Account-Servicing Payment Service Provider) - and the terms issued by the EBA are onerous for the TPP and their client to comply with.
- The EU has thus caused numerous incumbent and new market actors to invest sizeable amounts – *but nothing works!*

Manner and timing of EU interventions pulls the rug from under innovation and value-added services

The manner and timing of the EU's interventions has been such as to stifle any Value-Added Services being constructed by individual market actors. This is explicable because the SEPA Schemes themselves are subject to an annual change cycle. Then legislation - like Payment Services Directive - is subject to the following process:

- Passed in 2007;
- Implemented by 2009 latest;
- EU-level review of impact kicked off in 2012, 5 years after it was passed but only 3 years after implementation;
- Results of review published in 2013;
- First draft of PSD2 published in 2014;
- PSD2 passed in 2015;
- PSD2 to be implemented by end of 2017 latest;
- EU-level review of PSD2 scheduled for 2020 with results of review in 2021 and new ideas for of PSD3 in 2022, and so on….

The ground is always shifting: if one invests in a Value-Added Service there is a good chance that what you have done will be enclosed in a future version of the SEPA Scheme that is open-to-all and mandatory-for-all, or else what you have done will be legislated on. Then the version you invested in will not be the one that is mandatory. You did not just waste your investment money on your VAS, you have to pay to deconstruct it and build the mandatory version in its place, and migrate all your customers from your version onto the mandatory one. Once you launch your Value-Added Service you can rely on 1-3 years as a maximum period during which to obtain your return-on-investment.

Payments is a capital-intensive business, with long development lead-times, and thus requires a certainty of an extensive payback period in order for the investment to make sense in the first place. In the EU the total lifetime of any "market space" for VAS can be no longer than 3 years. Since typical VAS would probably take 1-2 years to design/construct/test/implement, you have a maximum window of 1-2 years after implementation to earn your payback, or risk the rug being pulled. This is non-viable. The only services that will exist will be the mandatory ones, in the "Basic" layer, with a low common denominator of feature and function, but at least they will be cheap.

EU interventions going into the fine detail

The EU's interventions contradict any illusion that the EU believes in the power of the market, or any freedom in markets for buyers and suppliers to react together so as to create value. The EU's interventions have been the more damaging for not being limited to creating a framework for the market to operate within, but in extending into the fine detail of market practice and operation.

For example, the interaction between TPPs and the incumbent banks should, according to the European Banking Authority, be subject to "strong customer authentication" both at set-up and at the resumption of a service if the customer has not used it for a month. That is all very well, but its current definition of "strong customer authentication" is so stringent that industry experts have stated that, not only will it inhibit these same new players from getting into the market at all, but it will cause incumbent players to alter existing products back to where they were in 2005.

EU interventions subject market actors to unmanageable risk

The EU's intrusive stance in the payment business is exposing market actors to risk over which they have no discretion and which are very hard to mitigate:

- The SEPA Migration End Date Regulation dictates that no bank acting for a payer under the SEPA Direct Debit scheme can refuse a claim from a bank acting on behalf of an originator, simply on the basis of the identify or country of the bank;
- At the same time Payment Services Directive gives the payer an absolute right to call upon their own bank to pay back a Direct Debit up to 42 days after the date of debit: the payer's bank then has to claim back off the originator's bank, that is if that bank still exists. The bankruptcy of the originator's bank does not invalidate the claim of the payer on their own bank;
- To monitor that risk, the payer's bank would have to maintain an inventory of all direct debit claims paid, by originator bank, that were less than 42 days old, but it could not ask for security against the risk of the payer reclaiming, either from the payer themselves or the bank: it is an unmanageable risk for the payer's bank;

- Similarly, the Interchange Fee Regulation requires a merchant to accept all brands and all issuers of a card type, if they accept it at all. So, if they accept Mastercard, they must not only accept Maestro and Mastercard World, they must accept the card regardless of which organisation has issued it, which could include banks from any country, eMoney Institutions, and so on. The merchant thus has imposed upon them a much higher risk of parting with goods and services and not getting paid.

Conclusion

The EU has spent 15 years forcing the EU payments market into compliance with its theoretical market model. It has forced many market actors to invest to achieve just a different version of what they already had. Its attempts to create new market actors via one set of legislation have been inhibited either by another set of its own legislation or by mistake.

At the same time as encouraging new actors, it has undermined the business of the incumbents and, in doing so, eliminated many revenue streams that might have justified new entrants entering the market. This is the EU's payments paradox. Its model has also been a failure – Value-Added Services have not emerged, and national markets have had to invest to rebuild the basic services that the basic SEPA Schemes did not contain, their being sub-basic when marked against what Member States already had on 1.1.1999.

This is incompetence on the grand scale and the UK needs to take back from the EU the right to set the rules, in this area as in many others.

Summary of
The EU's Payments paradox

Fifteen years of incoherent legislation and value destruction
– now facilitating the financing of terrorism

- The EU has legislated extensively to harmonise payments in euro – and the same legislation applies to all EU Member States and their currencies, and thus represents a cost to the UK;
- The legislation has been incoherent, and recent, major contradictions have included:
  - Passing several Directives to counter the financing of terrorism, but then enabling any new-arriver to get a bank account, bypass the normal checks, and then start exchanging money with other new-arriver members of their network using mainstream payment methods;
  - Elimination of fees in card transactions supposedly (i) to foster the digital economy (ii) to cut cost and enhance transparency, which could lead to consumers having to pay to have a credit and debit card, and then reverting to using cheques and cash; and,
  - Rigorous security procedures to be obligatory for a new class of payment company that the EU wishes to foster, procedures that could block their own viability and also lead incumbent banks to withdraw existing services from current customers, putting back the evolution of cards and mobile payments by ten years.
- The legislation has removed any economic basis for investing in the payments business, whilst supposedly attracting new entrants and fostering new services;
- No new services have emerged, though: the EU is wedded to a theoretical market model consisting of a Basic Layer of services, which are free and which act as enablers for the Value-Added Layer of services, where competitors vie for customer business on the basis of feature, function and price;
- The EU has intervened so frequently and at such a level of detail as to destroy the value of the business to the incumbent banks and to negate the rationale for investing in any Value-Added Services;
- At the same time new entrants are encouraged without it being assured that they have the basic ability to start trading;

- While the EU has legislated to create a harmonised payment experience in euro payments – called Single Euro Payments Area – the harmonisation has led to the creation of obligatory “core & basic” payment schemes – more basic than existed already in Euro Member States;
- Thus, the businesses in these Member States firstly have had to spend money to go backwards, and then secondly to rebuild at a national level to replace what SEPA removed – resulting in a lack of harmonisation and a back-to-square-one all round.
- This would be funny if these interventions did not add up to an unmitigated disaster and waste of resources, and if the UK had not had to invest significantly in processes that have as their main objective the shoring up of the euro – which it is not part of.

About the author...

Bob Lyddon

Bob Lyddon is an experienced management consultant both privately and with PwC. Recent engagements include running an international banking alliance, advising small payment providers how to access UK payment systems, and advising a major player in global payments as to the opportunities and threats arising from the establishment the UK's Payment Systems Regulator.

With PwC Bob managed several Euro implementation programmes. Prior to that, he had a diverse 17-year career in international banking, encompassing Transaction Banking, syndicated loans, export finance and derivatives.

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The Brexit Papers is a series of detailed essays designed to ask questions and provoke debate about the policies and strategies required to ensure the UK enjoys as optimal and clean a Brexit as possible. In this, the third, Bob Lyddon exposes the failure of it Payments regulations, which the UK needs to escape.

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