



Driving the SEPA Train: How to Implement the SEPA Cards Framework

ARTICLE

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The SEPA Cards Framework (SCF) has now been agreed, but Europe's banks and schemes must now focus on their greatest challenge - how to make SEPA a reality

How should a SEPA now be effectively implemented across Europe?

Introduction

The long awaited SEPA Cards Framework (SCF) has, at last, been unanimously approved by the European Payments Council (EPC) and released to an expectant European card business. Earlier this year it seemed doubtful that banks would ever agree a plan to liberalise Europe's notoriously complex domestic debit schemes and processing infrastructures. Despite divergent views, and threats of work-around/parallel solutions, an agreed plan for an open payments market has been delivered.

However before the SEPA cards train can leave the station, to use the European Central Bank's (ECB) recent railway analogy, a standards rail track needs to be laid, a network to connect the carriages and incentives and funds to steam up the engine if its destination of 2010 is to be reached. Co-ordinating all these elements and leading the initiative is now the formidable challenge facing Europe's cards business.

With hindsight agreeing the SCF was perhaps the easy bit, for as all legislators know new laws only work if they can be implemented and enforced. Despite the strong support of banks, the EPC, the ECB and the European Commission (EC), there is now a fear that the scope and scale of change required to implement SEPA will be beyond the leadership and management capabilities of all the parties.

The SCF has been developed by a committee of experts who have a solid understanding of Europe's cards business and infrastructures. But because of limited time there has been relatively little research and no definition of business requirements (difficult when primarily mandated by the ECB and the EC!). As a result, there is a shortage of detail and limited recognition of what has to be done to implement the SCF. In addition standards and guidelines must be delivered by end 2006. At this stage few can second guess their scope. At a minimum there should be new standards for SCF compliant debit (if not ICS branded) for POS to host transactions and for back end clearing and settlement. However, many argue that now is the time to implement common terminal application standards to cut the cost of POS devices. Also many argue that best operational practice includes removing the blockage of positive card file checking and PIN validation at interbank hosts if processing markets are to be opened up. New rules will be required for best practice scheme governance practice and national debit needs a common chargeback process for consumer redress.

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Implementation will be complex, for a network will be required to link all banks to all SEPA area debit card schemes for authorisation, clearing and settlement. Total implementation costs for cards alone could be as high as €7 bn to €8 bn. A great deal of detail has yet to be specified before planning and implementation can commence. Many are unsure that the current EPC structure can manage both the specification and delivery of Europe's largest ever payments infrastructure project.

The purpose of this paper is therefore to review past European interbank implementation models and to use components to build four strategic scenarios or implementation options that Europe could adopt for SEPA and the SCF.

Learning from History

So what does history tell us about past interbank projects? At a national level Europe has often been successful in implementing card payment infrastructures. The most successful have been those managed by the smaller countries (Portugal, Denmark, Netherlands, Norway, Belgium and Austria) who built complex and sophisticated ATM and POS infrastructures speedily and generally to budget. Could these projects provide models for SEPA implementation? The elements of success were typically: a well thought through consumer and merchant proposition; a good business case; strong commitment by the largest banks; a PIN based fully online central switch; rapid agreement of standards plus the creation of an interbank company to act as a focal point for all activities, including implementation.

However, not all aspects were successful. A major criticism was that ATM/EftPos projects were driven by technologists who indirectly created Europe's over complex national infrastructures. Some countries spent too much time on policy and analysis delaying decisions to proceed. In the UK, business and commercial requirements became mis-aligned with the technology strategy leading to failure. In several countries bankers omitted to consult merchants creating a strong resistance to commission fees. Finally, in too many countries banks delegated too much authority to their interbank institutions sowing the seeds of many of today's problems. So there are many lessons to be learned from the European ATM/EftPos experience.

“Are components of EMV possible models for SEPA implementation?”

SEPA (and the SCF) is an unusual interbank implementation in that it is an enabling project which, when live, will open up the domestic current account to pan-European access, but which has a strategic long term economic business case that shows few short term benefits to banks. SEPA also suffers from a weak consumer proposition. In these respects SEPA has similarities with EMV, also a mandated development. Are components of EMV possible models for SEPA implementation?

Although EMV implementation has been broadly successful it will have taken almost 10 years from concept through to final implementation. Lack of a strong consumer proposition and business case, plus its Anglo-French semi-online foundations have caused resentment and delays in several countries. Without the International Card Schemes (ICS) liability shift mandate which incentivised the co-operative and penalised late participants, it is unlikely that EMV would have ever been implemented. However from a standards setting perspective, EMV has been very successful with the basic set developed rapidly over 12 to 18 months. Their evolution has been greatly aided by the creation of EMVCo. Again, can the EPC also learn from the EMV experience?

So what governance and implementation structures should be adopted for the implementation of the SCF? Using the historical perspective, four strategic scenarios have been constructed. These are described and reviewed within the following paragraphs.

Scenario 1 – Current Open Market Strategy

The current strategy is that by the end of 2005 all of Europe's card schemes will have presented their plans for SEPA/SCF compliance and implementation. Thereafter (according to the 2004 road map) standards, business and technical specifications will be developed by end 2006. Piloting will be during 2006/2007 and gradual adoption from 2008 to 2010, after which SEPA will become a reality. The complete project will be monitored by the EPC, although the concept relies heavily on the delegation of the implementation leadership to schemes and banks. It also assumes that a mixture of ICS initiatives and alliances will drive inter-operability. There will be no centrally provided networks. Banks and schemes will develop on the basis of open market principles, either building their own networks or commissioning the processing sector to deliver solutions.

The strengths and weaknesses of the current plan are summarised within Table 1.

Strengths	Weaknesses
<ul style="list-style-type: none"> • EPC monitoring • Leverages banks ownership of schemes • Open market competitive principles for network construction • Strong commitment by largest banks 	<ul style="list-style-type: none"> • Poor history of open market developments • No central control or network • Voluntary body – EPC’s limited resources • No experience of implementation • Policy/strategy mixed with execution • No mandates incentives/penalties • Aggressive delivery dates

Table 1: Scenario 1 – Current Open Market Strategy

The advantage of this scenario is that the EPC monitors events, enabling continuity between policy and execution. Banks, as owners of schemes, can influence their plans given their strong commitment to SEPA. Open market competitive development of the infrastructure should result in a modern efficient network to support all debit schemes.

However, there are also weaknesses. First, Europe has a poor history of open market infrastructure development. Germany’s complex three party model is the major example and this has failed so far to deliver high EftPos usage. Almost all other markets (Spain is one exception) use a single central interbank driven solution or one partly supplied by the ICS. Second, the EPC relies heavily on voluntary resources and has a small secretariat and budget. Third, there is no collective pan-European interbank experience of co-operating, planning and managing such a large project spanning 27+ countries, 7k to 10k banks and 15 to 20 schemes. So strong leadership is required. Fourth, the current structure breaks a governance nostrum by mixing policy with execution which could result in EPC policy makers being drawn into micro managing, planning and implementation. Fifth, the EPC simply does not have a mandate to motivate schemes and banks to implement the SCF. It is unable to easily construct incentives and penalties to ensure delivery dates are met. Finally, the original 2004 roadmap has become out of date. Given Europe’s history of recent major project delivery (EMV) the timeline set is unlikely to be met.

“the EPC simply does not have a mandate to motivate schemes and banks to implement the SCF”

Scenario 2 – SEPACo

Under this scenario the EPC accepts that a separate governance structure is required for SEPA/SCF implementation. Banks also accept that given the scale and scope of SEPA the project must be professionally managed and fully funded. Thus implementation is handed to a separate implementation only company, SEPACo, with a powerful mandate to co-ordinate, project lead, plan, monitor and manage the complete implementation and infrastructure build process. SEPACo would be funded by the EPC members and have a substantial budget and staff, who would be sourced from member banks wherever possible. SEPACo would also be responsible to the EPC for co-ordinating and commissioning best business/operational practice guidelines, technical standards and network architecture. SEPACo would manage the umbrella project office and own the macro SEPA plan for the duration of the project. One of the first actions of SEPACo would be to develop a new implementation strategy and standards with appropriate phases which would ensure key deliverables by 2010, but which would extend the complete project by a further two years. SEPACo would also be responsible for selecting network suppliers to link SEPA compliant schemes.

Finally, EPC member banks would also give the EPC the authority (and a mandate) to incentivise those banks and schemes that deliver to target and to penalise those that do not.

The strengths and weaknesses of this scenario are summarised within Table 2.

Strengths	Weaknesses
<ul style="list-style-type: none"> • EPC provides leadership • Professional project managers (lower risk) • Realistic road map construction • Separation of policy/execution • Incentives and penalties 	<ul style="list-style-type: none"> • Cost of SEPACo • Does not deliver an infrastructure • No guarantee of success • EPC member resistance to penalties

Table 2: Scenario 2 – SEPACo

The strength of this option is that it sends a clear message to the EC, ECB and to the banking sector that the EPC will lead and manage SEPA on a professional project management basis. SEPACo, as an arms length company, can focus on rapidly delivering standards and guidelines, build logical and manageable delivery phases, and plan, co-ordinate and maintain the complete project. As an independent entity it can also redevelop the roadmap and negotiate a more realistic phased plan with the ECB. However, the EPC retains control and continues to set SEPA policy. If members also give the EPC a mandate to penalise issuers and acquirers for non-SEPA compliant transactions beyond 2010, there will be a strong incentive to implement. The revenue stream could be used to fund future phases. Penalties, if sufficiently large, will substitute for SEPA's weak business case.

“SEPACo, as an arms length company, can focus on rapidly delivering standards and guidelines”

The primary weakness relates to the cost of SEPACo which could be €20m to €30m for each of the next seven years. A central co-ordinating team is no guarantee of success and members may dislike the concept of incentives and penalties. SEPACo is a temporary structure and does not operate an infrastructure which is left for banks and the commercial processing sector to supply.

Scenario 3 – New InfrastructureCo

Under this scenario the EPC decides to follow the traditional interbank model and create a permanent infrastructure company responsible for not only implementation but also the provision of a common pan-European network to link all national schemes. The network would seek to be equal to Visa and MCINet in terms of its core functionality and would include standard interface components.

The strengths and weaknesses of this scenario are summarised below within Table 3.

Strengths	Weaknesses
<ul style="list-style-type: none"> • Professionally implements/delivers • Avoids fragmentation • Equal to and competes with ICS networks • Delivers solution for direct debits/credits 	<ul style="list-style-type: none"> • High cost and risk • Uncertain volumes/efficiency improvement • Unfair cost sharing • Already exists within ICS

Table 3: Scenario 3 – New InfrastructureCo

The greatest strengths of this approach is that one organisation is responsible for all activities. InfrastructureCo specifies and then delivers a common SCF network which will include the core value adds, such as chargeback processing. The approach avoids the potential fragmentation that could result from an open market solutions or concepts such as those promoted by the Berlin Group. The network would also compete with the ICS networks and could at the same time deliver a network solution for direct debits and credits.

However costs of development could be very high (€200m+) as would be the risk of time over-runs. Volumes could be low, unless domestic authorisation, switching, clearing and settlement can be included (already provided by the existing interbank infrastructure at marginal costs). In addition, the future existence of domestic card schemes in the smaller EU countries is uncertain. Potentially six schemes could migrate to ICS for domestic and intra EU usage, leaving France, Italy and Germany (possibly) as the major national schemes. The rest of Europe may object to funding a network solution just for these countries. Finally, such a network would replicate those of the two ICS both of which have the potential to provide an alternative processing service.

Scenario 4 – Regulated Implementation

Under this scenario the EC decides that SEPA and the SCF will only happen through regulation. A new regulation is passed, based on the SCF concepts, which is highly prescriptive (and which goes well beyond the three EPC policy frameworks) mandating the key deliverables and implementation timetable, the methods to be adopted to ensure these are achieved and the penalties/actions if not. There will also be a similar tightening of the New Legal Framework (NLF) to ensure a solid legal basis for SEPA.

The strengths and weaknesses of this approach are summarised within Table 4.

Strengths	Weaknesses
<ul style="list-style-type: none"> • Ensures all schemes and banks sign up to SEPA/SCF • Penalties strong motivator • Level playing field for competition • Regulations more directive than SCF • Support from some schemes 	<ul style="list-style-type: none"> • Pioneering regulation of standards specifications • Banks work to rule – work arounds • Unintended consequences and collateral damage • High risk project – EC micro manage • Failure damages EC credibility

Table 4: Scenario 4 – Regulated Implementation

Banks are law abiding institutions and as Regulation 2560/2001 has shown, the EC can develop regulations quickly. Penalties and fines will also be a strong motivator for the sceptics to join. Regulation will create a level playing field for competition beyond 2010. Some of the SCF compromises and lack of clarity can be redrafted and improved. Finally, some schemes may prefer regulation and some have already indicated that this is their preferred approach.

However there are downsides. Interbank standards, business and technical specifications emerge from a banking consensus. So far no regulator has attempted to define such documents. As the Australian experience shows, regulations can have unintended consequences, often causing collateral damage to those they were designed to benefit. Traditionally regulations become targets for work arounds unless their wording is very precise. Finally, this is a high risk and expensive infrastructure project into which the EC could be drawn to

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micro manage priorities and deliverables, if there is slippage. Politicians know to their cost the consequences of meddling in high profile projects which ultimately fail.

Conclusions

So which of these implementation options should the EPC, the ECB and the EC adopt? Table 5 provides a summary. Scenario 1, the current voluntary open market strategy, appears high risk and will be difficult to manage. Scenario 3, the creation of a new interbank body to specify, plan, deliver and operate the SCF framework, is high cost and barely justifiable on the predicted volumes. Scenario 4, the end to end regulation of SEPA and the SCF and the mandating of standards, deliverables and timelines, could expose EC regulation as a paper tiger, damage the EC’s reputation and is highly unlikely to deliver SEPA.

Scenario	Feasibility	Risk	Complexity	Cost	Certainty of Delivery
Scenario 1 Current Open Market Strategy	**	H	****	L	**
Scenario 2 SEPACo	****	M	**	M	***
Scenario 3 New InfrastructureCo	**	M	***	M/H	***
Scenario 4 Regulated Implementation	*	H	*****	H	*

Table 5: Summary Assessment of Scenarios

This leaves Scenario 2 (or a variant on the concept) whereby the EPC leads and Europe’s banks fund a temporary but dedicated and separate standards and project management team to co-ordinate SEPA over the next seven years and renegotiate the road map. In relative terms, the costs are modest and if correctly lead and staffed, SEPACo could have a major impact on reducing risk and achieving the major milestones.

“the time for leadership by osmosis and voluntary project management is over”

So the time for leadership by osmosis and voluntary project management is over. The SEPA train, carriages and railway tracks cannot be delivered at zero cost and without strong central co-ordination. Unless Europe’s banks quickly fund, the SEPA engine will never leave the station no matter how clear the final destination.

Peter Jones

About PSE Consulting

PSE Consulting is a leading European payment business and technology consulting organisation. The company was founded in 1991 by Peter Jones and operates from offices in London.

PSE Consulting is a founder member of the European Payments Consulting Association (EPCA), an association of like consultancies operating in six European nations.

PSE Consulting provides independent advice to many of the European institutions mentioned within this article and to many other players who are currently shaping the European debit market place.



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