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Recent developments and policy challenges affecting large-value and retail payment systems in Europe

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It is a great pleasure for me to be here in Madrid to share with you some thoughts about recent developments and policy challenges affecting payment systems in Europe.

Indeed structural changes are underway in Europe that should have a significant and positive bearing on the efficiency and safety of the payment infrastructures, notably in the wake of the implementation of the TARGET2 and the SEPA projects. Both projects are part of the overall process of the Lisbon agenda which aims at making the European Union "the most competitive and dynamic knowledge-driven economy by 2010".

However, for Europe to reach that objective in the field of payment systems, a number of collective challenges have to be addressed, both by private actors and public authorities. Those challenges range from the redefinition by private actors of the boundaries between cooperation and competition, to the adjustment by public authorities of the legal and regulatory environment in which payment systems operate.

In that context, the Eurosystem's central banks have a key role to play, given their statutory task of promoting the smooth functioning of payment systems in euro.

I will first review the key issues we are facing in Europe in the field of payment infrastructures. Then, I will discuss the current and possible future roles that the Eurosystem's central banks can play in that field.

1. Key issues in the field of payment infrastructures today

The three main issues I see as regards payment infrastructures today in Europe could be summarised as follows : (1) which role for payment infrastructures to support the European financial integration? (2) Which place to give to technological progress in the field of payment systems? (3) How to ensure business continuity of payment systems ?

1.1. Supporting the European financial integration

The share of payment systems in money transfers between financial intermediaries is nearly 80 %, versus 20 % for the traditional correspondent banking arrangements. So, payment systems are essential for the financial sector as a whole and, therefore, can be considered as a key enabler in the process of the European financial integration.

Such contribution of payment systems to the financial integration is embodied in the TARGET2 and SEPA projects. Both projects aim at the harmonisation and consolidation of the European "network" of payment infrastructures. While large-value payment systems have already attained a high level of integration and will further progress with the launch of TARGET2, retail payment systems are still very fragmented.

In the segment of large-value payment systems, the degree of integration has increased very quickly. The rationale for setting up the two European-wide payment systems that currently exist, i.e. TARGET and EURO 1, was clearly to face the challenge of the EMU. TARGET2, which is due to go live at the end of 2007, will further improve the degree of integration of wholesale payment infrastructures and will represent a major step forward in their consolidation. It will provide to its users fully harmonised settlement services and prices across Europe, supported by a single shared platform.

An important issue which is now under consideration is how TARGET2, as "backbone" of the euro market infrastructure of the euro, can best contribute to the integration and consolidation of the securities settlement systems with which it is going to interact. Should TARGET2, as announced by the Eurosystem and implemented in the system's specifications, support a wide range of interaction modes in order to foster competition between systems and let market forces select the most efficient one (i.e. the so-called no prohibition no compulsion principle) ? Or should TARGET2 influence that selection process by limiting the interaction modes to only one in a long-term perspective? It goes without saying that in the latter case the Eurosystem, given its statutory responsibilities, can only select the most efficient interaction model, namely a model of settlement of cash and securities, which is in real time as it is the case in the US for instance, and which is integrated in a single platform.

In the segment of retail payment systems, the situation is quite different. Retail infrastructures are still separated by national borders and characterized by a high degree of diversity. A number of local payment systems concentrate the clearing and settlement of all retail national transactions. In addition, the execution of cross-border payments go through several dedicated arrangements such as international card schemes, banking “clubs” or the EBA’s STEP 2 system.

The SEPA project aims to put an end to such fragmentation by introducing, as from 2008, European payment instruments which are going to replace national ones by end-2010. The vision is that by end-2010 all retail payments in euro are carried out as easily, efficiently and safely across Europe as within national borders. For this vision to become a reality, a key enabler is that retail payment infrastructures become interoperable and consolidate.

The outcome of theses changes on retail payment systems is uncertain. It may lead to various structures, ranging from a natural monopoly exercised by one infrastructure that would encompass most national and cross-border payment flows, to the competition between several systems. However, whatever the structure, the challenge will be to find the right balance between two objectives : (1) reaping economies of scale and scope and (2) fostering competitive market conditions and behaviours.

1.2. Keeping pace with technological progress

The second issue for payment infrastructures consists in keeping pace with technological progress. Payment systems are made up of IT networks, hardware and software. As a consequence, technological progress is a key driver for enhancing the way payment systems are designed, operated and used. I will highlight a few significant examples of recent technological developments.

The first half of the nineties experienced a major transformation in the design of large-value payment systems with the widespread introduction of real-time gross settlement (RTGS) systems. In a second step, further advances in information technologies have made possible new designs like the so called “hybrid systems”, i.e. systems that settle in real-time but, at the same time, minimise liquidity needs thanks to highly sophisticated optimisation mechanisms.

In short, advances in information technology allowed large-value payment systems to settle faster, with a lower amount of liquidity and at a lower cost.

On the retail payments side, technological progress should also allow safety and efficiency gains beyond those which have resulted, for instance, from the implementation of cheque truncation or those that are expected from introduction of the EMV (Europay Mastercard Visa) technology for card payments. Innovation has definitely an important role to play in in order to keep the SEPA project future-oriented and promote the use of new delivery channels for retail payments like the internet and mobile devices, or new types of services like electronic invoicing.

However, this flow of innovations come together with the entry in the payments market of new actors which do not always offer the same level of security as the traditional suppliers of those services, namely credit institutions. There is obviously a trade-off between, on the one hand, encouraging innovation by facilitating access to the payments market and, on the other hand, ensuring the safety of payments provided by setting prudential requirements on their suppliers. This challenge is at the heart of the current discussions on the "proposal for a directive on payment services in the internal market".

1.3. Ensuring business continuity

The third key issue I see is related to business continuity. Business continuity can be defined as a set of measures aimed at ensuring the continuity of service in various incident scenarios such as the failure of an infrastructure component, or the unavailability of the staff in charge of operating systems.

Business continuity has progressively emerged as a key issue to be considered for the design of payment infrastructures. In addition, several factors have recently led to overhaul our approach of operational risk : the spreading of real-time processing within payment systems, the growing complexity of technologies, the increasing interdependence between payment systems and the materialisation of risks such as terrorism or power breakdowns. All stakeholders - public authorities in charge of regulation and oversight, operators and users of infrastructures – have identified weaknesses as regards current practices. For example, incident scenarios impacting wide geographic areas have been overlooked.

In Europe, there is a broad consensus on the need to strengthen business continuity requirements. The ultimate objective is clear: business continuity should contribute to enhance the soundness of the financial system as a whole. But it is not obvious to renew business continuity procedures. Among the challenges to be taken up, I see two major ones : (1) how far to go without putting at stake the cost efficiency of the systems ? (2) How to ensure the necessary coherence of the efforts undertaken by stakeholders of different importance, submitted to different types of regulations, across the different financial centres that compose the financial system of the euro?

2. What roles for the Eurosystem

The Eurosystem has been quite active in the field of payment systems and is likely to develop further its involvement under its three roles of : (1) service provider, (2) facilitator of market and regulatory evolution, and (3) overseer.

2.1. Providing payment services

As a service provider, the Eurosystem has put priority on enhancing the efficiency and safety of its TARGET system, with the launch of the TARGET2 project.

TARGET2 will provide harmonised services and prices, efficient liquidity management and settlement mechanisms, while setting a new benchmark in terms of business continuity. The Eurosystems objective is to promote the use of real-time settlement services in central bank money, given their expected social benefits in terms of risk reduction in the payment process.

In the field of retail payments, the degree of the Eurosystem's central banks' operational involvement varies across countries. Most central banks provide payment services to public institutions. Some central banks also offer processing facilities to commercial banks by participating in private retail payment systems and/or operating an own retail payment system. The completion of the SEPA project calls for a specific effort of those central banks that are significantly involved in retail payment operations. They should lead by example, notably by supplying the new European payment instruments to their clients and by ensuring that the

retail payment system they operate complies with the interoperability principle enshrined in the SEPA project.

2.2. Acting as a facilitator of market and regulatory evolutions

Turning to the involvement of the Eurosystem in payment systems issues as a facilitator of market and regulatory evolutions, it is fair to say that this mode of action has been mainly used in the field of retail payments to support the SEPA project.

The SEPA project was launched in 2002 by the European banking community under the aegis of the Eurosystem and the European Commission. The banking industry has taken on the responsibility of delivering the SEPA products, in particular the specifications of the new European instruments. The European Commission, which grants a great importance to the SEPA project in so far as the latter contributes to the achievement of the common market and the completion of the Lisbon agenda, has elaborated a legal framework for payment services in the European Union. It made public, in December 2005, a directive proposal that should be adopted at the European level before being transposed in national laws by 2008.

Since 1999, the Eurosystem's central banks have been actively promoting, at European and national levels, the establishment of a SEPA. They proposed a vision which is now shared by all stakeholders, contributed to a constructive review of the banking community's deliverables and cooperated with the European Commission to address legal and regulatory impediments.

While the design phase of the SEPA project is almost completed, the next challenge is to ensure that migration towards the SEPA is well-organised and delivered. Because the starting point in each country is different, migration plans to the SEPA will primarily have to be organised locally. This should naturally lead to a further involvement of the Eurosystem's central banks at national level, at least to help co-ordinating the efforts of the wide range of stakeholders.

For example, the Banque de France and the French banking federation have created a national committee dedicated to the implementation of the SEPA. This committee gathers representatives of banks, different categories of users – public administration, corporates, retail business and citizens – as well as members of the French Parliament. It is in charge of coordinating works relating to the migration towards the SEPA. Having held its first meeting in April 2006, the committee foresees to adopt the French migration plan by October.

2.3. Overseeing payment systems

As overseers, the central banks of the Eurosystem have also contributed to the objectives of European financial integration, technological progress and higher resilience of the financial system.

So far, this contribution has consisted in developing and applying an oversight framework for retail payment systems, which contributes to establish safety and efficiency guidelines for the expected integration and consolidation of retail payment systems in the context of the SEPA project.

The need that the payment systems' regulatory framework keeps pace with the structural changes underway in Europe is likely to lead the Eurosystem's central banks to develop further their involvement as overseers, at least in two directions.

The first direction is the updating of the existing oversight requirements to new market realities. Work has already started in that respect. For instance, the Eurosystem is currently revising the oversight standard for systemically important payment systems relating to operational risk. This is because discussions and initiatives in order to strengthen business continuity management have taken place mostly at national level and have not systematically considered that the financial system of the euro operates as a euro area-wide network of interrelated markets, market infrastructures and participants. Therefore, the Eurosystem is preparing a revised version of its business continuity expectations for systemically important payment systems that should be integrated soon into its oversight policy framework.

The transformation of the payment infrastructures landscape in Europe should also logically lead to an updating of the oversight framework for retail payment systems. In particular, retail payment systems are about to become interoperable and face a consolidation process, which is likely to lead to the establishment of links between systems. Such links may potentially imply a spill over of risks from one system to another. Central banks will have to make their oversight function evolve accordingly. Oversight standards will certainly have to include the links between systems, as it is already the case for securities settlement systems.

The second direction for an evolution of the oversight activities of the Eurosystem is the extension of the scope of its oversight framework to the European payment instruments currently in the making and their associated clearing and settlement systems. Investigations are currently underway to elaborate an oversight framework for card payments.

Concluding remarks

Payment systems, which are significant contributors to the broader effectiveness and stability of the financial system, are currently exposed in Europe to specific structural changes notably as a result of pressures and progress towards financial integration in the euro area.

Integration and consolidation of payment systems have made progress, while remaining in line with expectations in terms of safety. However, further progress need to be made, notably in the field of retail payment services and infrastructures. In that perspective, the Eurosystem's central banks will continue to significantly contribute to these evolutions, but I believe that market forces should be and are likely to be the primary engine for such progress.