

# Pan-European successes and challenges in payment traffic



The SEPA project has had positive effects. This is the opinion of Hays Littlejohn, who became CEO of EBA CLEARING last year. The pan-European clearing house primarily processes SEPA payments for more than 4,800 reachable financial institutions. Instant payments will be added at the end of 2017. He discusses another hot topic in the following interview: blockchains.

**CLEARIT:** Mr. Littlejohn, EBA CLEARING views itself as a provider of pan-European infrastructure solutions for payment transactions. It operates two systemically important payment systems, among them the central clearing house STEP2. In addition there are also decentralized and bilateral infrastructure models in SEPA. How do you assess these concepts?

**Hays Littlejohn:** First of all, I would like to mention that in Europe there are only four systemically important infrastructures in the euro currency in total: TARGET2, STET in France and EURO1 and STEP2 from EBA CLEARING. I would like to state upfront that our company is a “joint venture” of our owners and participants; hence we do not issue assignments ourselves, but closely gear our work to the actual requirements of the participants. And EBA CLEARING’s primary assignment consists in providing a future-oriented, highly reliable payments infrastructure at a lower cost. This is important to keep in mind, since there are people who assert that clearing houses only seek to make profits, which is certainly not true.

**“With decentralized clearing, all these advantages turn to disadvantages.”**

Now, to answer your actual question: The main difference between decentralized, bilateral and central clearing is that the central approach, in my opinion, offers more advantages. First, it is much easier and less expensive to manage one rather than multiple channels; that also applies for oversight and stability.

And second, we can develop all the functionalities to be offered just once and then bear the costs for them collectively. It goes without saying that this is much less costly than it would be if each national provider were to develop them on their own. Economies of scale also result from multilateral netting, which enables our participant banks to better manage their liquidity.

Third, acting together promotes flexibility and reduces fragmentation because the connections are more network-independent. National requirements can still be covered in the process – through so-called additional optional services (AOS). One such AOS, for example, ensures that in Finland the extended remittance information service can be offered. And the great thing is that every other community is also free to use this AOS.

With decentralized clearing, all these advantages turn to disadvantages. And on top of that: The more infrastructure platforms and thus the more accounts there are, the more difficult it becomes to reconcile them. Risks may arise between the so-called clearing and settlement mechanisms (CSMs), such as settlement risks. From a regulatory point of view, things become even more complex, because the legal frameworks of different countries are not always uniform.

**In your position, it comes as no surprise that you are a clear advocate for the central approach. However, not everyone in Europe is as convinced as you are.**

Naturally, there are also experts who believe that the decentralized approach has more benefits. One of their arguments is that the bilateral exchange has functioned well so far – especially in Germany. Yes, the so-called “Garagenclearing” was a successful processing model for the big German banks, despite the internal costs for monitoring the various channels and administrating the corresponding contacts, for liquidity management, the allocation process and for backup facilities. However, Garagenclearing no longer exists today.

**“In my opinion, payment processing has already become a lot more efficient.”**

**One objective of SEPA was to make European payment processing more efficient and thereby to reduce costs for companies and banks. In your opinion, to what degree have these goals been met – after the successful migration to the SEPA schemes in 2014 and the migration of niche products last February?**

The European payments sector has come a long way since it started the SEPA project with the founding of the European Payments Council in Brussels in 2002. Perhaps we have not yet achieved all the objectives. In my opinion, however, payment traffic has already become a lot more efficient; what customers primarily notice is that intra-European payments today, as a rule, reliably reach the creditor’s account one business day after the payment instruction is issued. With the ISO 20022 message standard, it has also become much more structured, which in principle has generated added value for corporate customers, particularly when it comes to reconciliation and cash management processes. Furthermore, I see positive side effects for payment service providers, which can now further use their new standardized internal systems for SEPA for other services, such as for the clearing of pre-authorized card payments. EBA CLEARING already offers such a service – so far, in cooperation with the Deutsche Bundesbank, only for the German market, but the underlying concept is pan-European. This means that similar to the example in Finland mentioned previously, the STEP2 Card Clearing Service can also be used in other countries at any time. The fact we can process around five million transactions daily with this service alone speaks for the worth of the central, pan-European approach. This becomes even clearer when we look at the figures for the entire STEP2 platform – it processes over 40 million SEPA payments on a daily average, even more than 100 million on peak days.

**“This cooperative approach is part of our DNA, so to speak.”**

**You announced an infrastructure solution for instant payments a year ago. What has happened in the meantime?**

A great deal; last year we created our Instant Payment Task Force with representatives from more than 20 participant banks from across Europe worked on a blueprint until mid-2015. After this was published, we conducted a consultation process among our users. Finally, last September, the second version of the blueprint was published and meanwhile has been downloaded from our website over 700 times. This has contributed a great deal to exchanging ideas regarding instant payments and towards the further development of our initiative. At the same time, in close cooperation with our Board, we launched a request for proposal process to search for a technical service provider that shall support us with the development and implementation of a pan-European instant payments infrastructure solution. This request for

proposal has since been completed and we are now conducting contract negotiations with our preferred supplier SIA. The work of the task force was thus completed and it was recently replaced by the Instant Payments Project Working Group, which will accompany the development project. The project began in mid-April with 39 banks participating in the working group to contribute to shaping the system design and interface specifications. It is always important to us to work together in such a community and to remain in close dialogue with our participants, because then the result is agreed upon in advance and the acceptance broadly anchored. This cooperative approach is part of our DNA, so to speak.

#### Do you also have Swiss banks among your participants?

Unfortunately no; some banks and countries currently have other interests and challenges. Financial institutions from 14 countries are represented in the working group, some of which are active in multiple countries. A Swedish bank, for example, covers the Baltic States, while one from Austria covers the Eastern European countries. In this way we attain nearly 100% coverage in the eurozone. Both large and smaller banks are included. Therefore we believe that the project is very well supported and has gotten off to a very good start, but now we have to deliver and, according to our planning, we will be on time. At the beginning of June we will offer a first glance at the specifications, which will be published in the course of the summer, so that they are also available to financial institutions that are not part of the working group. Then the programming and implementation phase will begin, with completion by the end of the year. Testing shall begin in the first quarter of 2017, the pilot operation in the third quarter, followed by the go-live in November 2017.

#### That is an ambitious schedule.

Perhaps, but it is one that is feasible. Also because with the planned instant payment infrastructure solution we will again profit from the STEP2 components and thereby be able to shorten the development time. In addition, the transactions will be cleared individually in real time. We intend – similar to what you are doing in Switzerland with the new Paynet System for e-bills and direct debits – to introduce pre-financing to enable instant clearing and to avoid any default risk. The scheme conceived by the EPC specifies that a transaction with an amount of up to EUR 15,000 can be processed within a maximum of 20 seconds. In contrast, our blueprint specifies five seconds. This means that our banks generally prefer to process very quickly. In the beginning we primarily expect

P2P payments, but are also already anticipating B2B transactions; individual communities have expressed differing plans in this regard. However, as soon as usage is widespread and convenient apps and other applications are used by end-customers, B2C amounts can also quickly follow. By “quickly” I mean, in terms of infrastructure timelines, within several years.

#### Were instant payments initiated by the banks based on a needs analysis?

From my perspective, it is difficult to say what the banks think about this. I see two reasons that probably lent impetus concurrently. One is the Euro Retail Payments Board (ERPB), which had certain expectations. That was apparent in every meeting with ERPB representatives and in every ERPB paper. In December 2014, the ERPB called for the development of at least one pan-European system for instant payments. That was the starting signal for many banks in Europe, as well as for us. The other reason is that there are considerations regarding the question of positioning within the future payment processing landscape, which affects every bank and every other service provider in this area. A competitive, efficient and inexpensive infrastructure is naturally an important success factor here.

#### What happens when the debiting and crediting of accounts cannot take place in central bank money, because TARGET2 is closed over weekends, for example?

It actually is a challenge to be able to inject liquidity as necessary, if TARGET2 is not open. The ECB is currently analyzing what it can offer in such cases to avoid potential bottlenecks. It is to be assumed that an adequate solution will be placed on the table in the near future. Such bottlenecks could occur on weekends for B2B payments, which is very rarely the case today. As I implied earlier, it will still take a few years until business models change and the need for payments over the weekend grows. But perhaps the liquidity streams will be so predictable that no action will need to be taken.

#### An EPC working group is tasked with elaborating the credit transfer scheme for instant payments (SCT Inst). EBA CLEARING, as you have mentioned, also recently set up an instant payments task force. Moreover, the Euro Banking Association facilitates the Open Forum on Pan-European Instant Payments. How would you differentiate these working groups from one another?

Our task force was assigned practical work such as the creation of a blueprint for the area of infrastructure. The Open Forum launched in March 2015, which is logistically supported by the Euro Banking Associ-

ation, has a much broader focus, both in terms of topic and organization. It facilitates the continuous exchange of experience among the participants on instant payments. We at EBA CLEARING are just one participant among many in the Open Forum. The commercial field – merchants – are also represented. The EPC is ultimately in charge of developing the scheme and the rulebook, which we and other infrastructure providers, as well as the payment service providers, then implement.

**“Neither blockchains nor distributed ledgers, in my opinion, are of practical benefit for payments...”**

And finally, the inevitable question, which you are certainly expecting: What significance does the topic of blockchains have for EBA CLEARING? What opportunities do you see here?

It really is true that in recent times no conversation or meeting takes place without this subject popping up. Actually, we should be talking about distributed ledgers, since blockchain is a rather vague term. However, neither blockchains nor distributed ledgers, in my opinion, are of practical benefit for payments – at least for the time being. Allow me to explain using the example of our request for proposal for the instant payments infrastructure solution. In our request, we purposely left it up to the participants as to whether or not to integrate this new technology. Not one single vendor took us up on the idea. I believe it is still far too early to consider the use of this technology in payments. Besides the problems involving transparency, scalability, release management and the risk of manipulation, which were addressed in the last issue of CLEARIT, I would also like to highlight the following: The new technology requires that it must be possible to replicate every transaction everywhere in real time. That means nothing more than both bandwidths and storage capacities must be guaranteed for each participant. And all that may seem to be free of charge, but it is not. If the real costs are added up, then it really is infeasible, otherwise we would have done it long ago. In the central approach, we have backups, secured with duplicate backups. We need four to six data centers. According to the new logic, thousands, if not tens of thousands of new data centers must be set up which, it goes without saying, would be very expensive no matter how it were to be implemented. And with the ISO 20022 standard spread throughout Europe things get even trickier, because, for example, a pacs message with its 600-



Hays Littlejohn

800 characters is so richly filled with data that huge volumes of bits and bytes must be sent back and forth and saved. That is hardly expedient today. However, it is not just a matter of the sheer volume of payments – we are not only talking about our 45 million transactions per day, but about over 500 million retail payments throughout Europe. Even if we consider just one central bank system such as SIC, instead of one connection with its 350 participant banks, then 350 squared must be managed – because everyone would have to have a connection with everyone else. That would be the opposite of the central approach. Everything may be possible, but whether it makes sense is another question.

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