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INTEGRATION OF THE EU PAYMENT SYSTEMS: A "TOLERABLE STRAIGHT LINE"?

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The way to the EU single internal market, a pillar of the Treaty of Rome (1957), was paved only in the 1980s with the Commission's White book on "completing the Internal Market". This gave rise to an intense legislative activity, continuing until 1992, and a complete framework legislation for the creation of an extensive market, implying the development of economies of scale, competition and growth. Little or no attention was paid to matters of financial stability. After the introduction of the single currency (1999) and following on developments in the financial sector, considerable advance has been made in the integration of payment and settlement systems, for both wholesale and retail transactions. However the process still needs to be completed and the consequences of the recent economic crises seem to have damped down the momentum of and consensus on linear progress towards the economic integration in Europe. The impact of financial stability on the integration process can no longer be disregarded, and the costs of integration cannot be ignored. This paper has the objective of highlighting the economic and regulatory drivers of integration in payment systems after more than two decades of experience. Its main purpose is to contribute to a non-static view of integration. The main conclusion is that through the delays and difficulties of the integration process (i.e. resistance to changes on the part of national banking communities, asymmetries in the degree of integration of wholesale versus retail payments, slow diffusion of innovative payment instruments), a more realistic view of payment systems, as utilities for the financial sector, has finally emerged.

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I am now beginning to get fairly into my work; and by the help of a vegetable diet, with a few cold seeds, I make no doubt but I shall be able to go on, in a tolerable straight line.
(L. Sterne, Tristam Shandy, 1759)

1. Introduction

The way to the EU single internal market, a pillar of the Treaty of Rome (1957), was paved only in the 1980s with the Commission's White book on "completing the Internal Market". This gave rise to intense legislative activity continuing until 1992, and complete framework legislation for the creation of an extensive market, implying the development of economies of scale, competition and growth. Little or no attention was paid to matters of financial stability.

After the introduction of the single currency (1999) and following on developments in the financial sector, considerable advance has been made in the integration of payment and settlement systems, for both wholesale and retail transactions. However, the process still needs to be completed and the consequences of the recent economic crises seem to have damped down the momentum of and consensus on linear progress towards the economic integration in Europe. The impact of financial stability on the integration process can no longer be disregarded, and the costs of integration (required investment in infrastructures, increasing coordination costs, interdependencies, new practices and standards) cannot be ignored.

This paper retraces European policies and legislative measures aiming at integration in payment systems over the last two decades. The main phases of the process (launch of the single market, introduction of the euro, creation of the single euro payment area, aftermath of the 2008 crises) are identified through the adjustments and changes in the regulatory and economic approach adopted by the European institutions. The main conclusion is that through the delays and difficulties of the integration process (i.e. resistance to changes on the part of national banking communities, asymmetries in the degree of integration of wholesale versus retail payments, slow diffusion of innovative payment instruments), a more realistic view of payment systems, as utilities (like electricity, gas, etc.) for the financial sector, has finally emerged. As is already the case with the regulation of utilities of high public relevance, the recent strategy of European regulators includes the objectives of consumer protection, transparency, security and legal clarity.

The paper is organized as follows. In sections 2 and 3, we illustrate the creation of the single market in Europe and its economic rationale, with the liberalization of cross-border operations for financial institutions, including the provision of banking services, and the policies followed by the European Commission and monetary authorities during the 1990s. At that time, there was total reliance on market forces to help the integration of payment services while policy action was limited to the integration of large-value payments, with a view to the adoption of the single currency and single monetary policy. Sections 4 and 5 illustrate how, after the introduction of the euro, disappointment with the state of cross-border integration, particularly for small value payments, drove the Commission to move actively in this field, being less confident in a pure "market-led" integration process; the steps toward the introduction of the SEPA are described. In sections 6 and 7, starting from the economic consequences of the financial crisis (a new fragmentation of national markets, the sharp decline of interbank transactions and payments), the new strategies and the state of the integration of payment systems are outlined. We conclude with section 8, where we try to draw some lessons from the overview presented in the paper, providing elements of interpretation of some key features concerning payment services and a possible line that policies should follow to complete the integration process.

2. The White Book of 1985 and payment in the internal market in 1990

The single market is the core of the process of European integration envisaged with the Treaty of Rome signed in 1957 and its aim is to guarantee in Europe the free movement of people, goods, capital and services. The latter concerns the freedom for providers of services, including financial and payment services, to conduct their business in all member states. The free movement of capital and payments implies that capital controls and restrictions on currency movements are abolished and the supply of foreign financial services providers across the borders is made easier. Overall, the aim of economic integration is to provide citizens and companies with access to markets previously closed by national barriers.

The European economic integration started with a free trade agreement, abolishing custom duties and tariff trade barriers. However, the single market represents a much deeper level of integration by far, as it also aims at ruling out 'non-tariff barriers' that may reflect different legal and technical standards, often justified for health and safety reasons or for environmental or consumer protection.

The cornerstone of the European single market was the Commission's White Paper presented to the European Council in June 1985[2], with a view to achieving a thorough single market by 1992. This was endorsed by the then 10 member states with the European Single Act of 1986. These initiatives gave rise to an intense acceleration of the legislative activity, with almost 300 Commission's proposals for directives in the following years ahead of the set deadline of end 1992.

The European Commission conducted analysis of the potential impact of the single market. An important and much-quoted assessment was the so-called Cecchini report of 1988[3]. The results of the analysis showed a significant wealth effect of above 40% cumulated over a period of 5 to 6 years, i.e. an annual increase of GDP estimated between 4.5 and 6.5% for the twelve member states of that period. It calculated a potential price reduction by some 6%, due to competitive pressures, as well as the creation of two million new jobs. A number of analysis estimated that the expectations of the Cecchini report were overly optimistic[4]; however it is mostly agreed that the introduction of the single market had a positive impact on growth[5]

From the very beginning of the integration process, the sector of payments was considered an integral part of the more general financial sector. In 1990, the Commission issued a first document on 'making payments in internal market'[6], assuming that the benefits of the internal market will only be realised if cross-frontier payments operate as effectively as those at national level. In the Commission's view, the roadmap for the transition to a single currency should have been increasingly integrated with improvements to cross-border payment systems within the internal market, although they represented only 1% of total transactions in Europe as reported by the same document. The Commission was expecting a rapid increase in cross-border transactions and estimated the number of retail cross-border payments at 400 million each year up to the end of the century. At that stage, the Commission was aware of the peculiarities of the payment sector and of the extensive efforts needed to create new European standards and infrastructures with the cooperation between

[2] EU COMMISSION, *Completing the Internal Market. White Paper from the Commission to the European Council*, 28-29 June 1985. COM (1985) 310 final.

[3] CECCHINI – CATINAT – JACQUEMIN, *The European challenge 1992: the benefits of a Single Market*, 1988, Gower: UK.

[4] For example, a study presented in 1994 (Harrison, 1994) quantified the effect at just 0.5% of the European GDP or, including the long-term effects, at 1.2%.

[5] An assessment of 2007 by the European Commission and other estimates found that it had generated additional income of nearly above 2% per year between 1992 and 2006.

[6] EU COMMISSION, *Making Payments in the internal market*, 26 September 1990. SEC (1990) final.

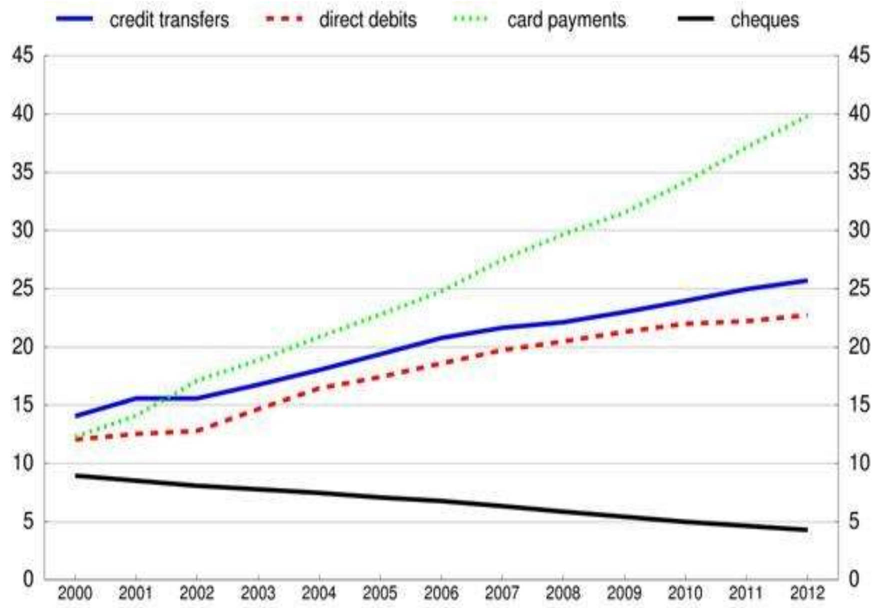
banks and other institutions of the financial sector. However, full reliance on competition and on the incentives provided by the openness of the single market was not questioned.The Commission intended to be a catalyser of the process, i.e. listing the possible solutions to the lack of a European Automated Clearing House (EACH), while underlining the potential benefits for non-financial institutions (i.e. retail customers, SMEs, corporates, public administrations) of an integrated retail payments market.

In the same perspective, in a working document of 1992 the Commission laid down a detailed programme of work for the financial sector in the area of payment systems, taking into account all aspects involved in a cross-border transfer in Europe, namely costs and prices, time of execution, technical standards, characteristics of payment instruments, clearing and settlement services, membership rules, information to customers, statistical reporting and legal framework[7]. As for the payment instruments to be used in cross-border transactions, the Commission did not aim directly at harmonizing the different payments habits of the member states, nor at fostering the use of non-cash electronic payments. At that time, the composition of non-cash payments by instruments (cheques, credit transfers, other) in most EU member states showed the dominance of cheques (63% of total in FR, 49% in Italy, 55% in UK, 31% in Belgium, but only 9% in DE). In the following years, the trend in the composition of mostly used payment instruments was very different: credit transfers and direct debits prevailed as rules and standards of such payments were easier to be harmonized than those of cheques[8].

[7] EU COMMISSION, *Easier cross-border payments: breaking down the barriers*, 27 March 1992. SEC (1002) 621 final.

[8] See: Chart A, Table 1.

Chart A: Use of the main payment instruments in the EU (2000-2012)
(number of transactions per year in billions, estimated)



Source: ECB, Blue Book, 2013

3. The economic rational of the Single Market

From a theoretical perspective, the single market was expected to provide significant welfare gains and stimulus to innovation. Through the creation of an EU-wide free-exchange area, the European economy in all sectors would have benefited from large economies of scale, increased competition and extended price reductions, which in turn would have enhanced investment, growth and employment. Hence, the removal of barriers to free movement of economic resources would have led automatically to market integration and economic convergence among member states. The costs and the possible drawbacks of integration, in particular the vulnerabilities related to financial interdependencies which may affect financial stability, were not investigated.

Extended cost reductions were envisaged via the harmonization of production and quality standards, enabling to easily sell products within the European market. A wider market was thought of as conducive to possible economies of scale for companies, particularly in sectors with high fixed costs, as they would have also optimized production processes via cross-border merger and acquisitions. Competition should have increased, due to lower entry barriers, while inefficient companies would have been put under pressure by more efficient competitors. This would have reduced the mark-ups in protected markets, bringing about price convergence throughout Europe and the cost advantage would have partly passed on to consumers. Finally, financial market integration and liberalization would have made financial transactions easier and cheaper; benefits of financial integration were thought to come from improved allocative efficiency. Given the high level of cross-border activities, the financial and monetary markets were expected to profit more than other sectors from the removal of national barriers to monetary transactions.

The European single market was introduced at a time where the international context was primarily supporting the progressive development of market-friendly financial supervision and financial regulation, implying the dismantling of a system of structural controls of financial institutions. A full-fledged system of prudential regulation was introduced for financial markets and institutions, where a set of rules, such as those agreed in Europe with the creation of the single market and mostly based on the recommendations of the Basel Committee of Banking Supervision, constituted basic requirements, while allowing financial institutions to operate without any structural constraints. The system of universal banking fully developed from this legislative framework. Within this context, the large European single market was oriented towards opening competition since its origin, i.e. to the full use of market forces, as this was enhanced by the possibility for financial institutions to operate cross-border. The European Commission was tasked with fostering competition making use of competition rules set out in the Treaty and that also applied to the banking sector.

In order to accelerate the 'natural' convergence to the single market by the different member states, the Commission adopted a regulatory approach based on the principle of "minimum harmonisation" and "mutual recognition", i.e. member states should recognize foreign national regulations concerning goods and services across borders, while respecting some basic requirements.[9] The trade-off between the time and the contents of the harmonization of the economic infrastructures in member states was solved pragmatically laying down essential requirements, compulsory in all member states: the fulfilment

[9] The principle of mutual recognition first entered into Community law following the sentence of the European Court of Justice of 1979 known as the case *Cassis de Dijon*.

of such requirements entitled products and services to free movement. The compliance with minimum requirements draws a clear distinction between what needs to be harmonised and what may be left to mutual recognition of different national regulations and standards.

The new legislation in the banking and financial sector followed such principle of mutual recognition: it introduced the European passport or single banking license, allowing a financial institution authorized in one member state to open branches or provide services cross-border in all other member states on the basis of the so-called home country control.

In the field of payment systems, the regulatory approach followed a different path for retail payment systems and for large-value ones. Since large-value infrastructures were designed for wholesale payments (including monetary policy operations) mostly consisting of interbank operations or treasury and currency transactions of large enterprises, a set of minimum harmonised features were defined only for large value payment systems. In September 1992, the Working Group on EU payment Systems, a group formed by EC central banks, under the lead of Tommaso Padoa Schioppa, identified the issues of common concern for central bankers in the field of payment systems. In November 1993 the report *Minimum Common Features for Domestic Payments Systems* fixed «the harmonisation of some of the main features of the large-value interbank funds transfer systems (IFIS)»[10]. Building on that report, the decision was taken by the Council of the European Monetary Institute (EMI) in March 1995 to link each national Real Time Gross Settlement (RTGS) system in order to have a cross-border RTGS system ready by the start of the EMU. The result was the Trans-European Automated Real-time Gross settlement Express Transfer (TARGET) system that successfully started its operations on 4 January 1999. The decision of the EMI Council was crucial for the developments of the infrastructures needed for large value payments to accompany the introduction of the single monetary policy and the monetary union. However, as similar policies were not undertaken for the whole of the infrastructures and for the retail sector, it also

[10] Report to the Committee of Governors of the Central Banks of the Member States of the European Economic Community on *Minimum Common Features for Domestic Payment Systems* prepared by the Working Group on EC Payment Systems, November 1993. The report established 10 principles covering the following areas that required specification in terms of minimum common features: access conditions, risk management policies, legal issues, standards and infrastructures, pricing policies and business hours. As a follow-up to the publication of the report and as a way to further reduce risk, EU central banks commonly decided that an RTGS system should be set up in each EU country for the relevant national currency.

contributed to delay the integration of retail payment systems in the EU. For the retail sector, up to the first direct intervention in 1997 with the proposal on cross-border credit transfers[11], the European Commission relied on recommendations to the banking industry, while waiting for the positive outcomes of the incentives provided with the principles of the single market. So, basically, the Commission, and also the monetary authorities, waited for the banks to find solutions to the peculiarities of payment systems, especially of the payment facilities to be used by retailers and end-users, and in particular to bear the burden and the high fixed costs for new infrastructures, prompting a quick integration of the different national systems. Indeed, the role of payment systems as utilities[12], as well as the degree of market power of incumbent financial institutions operating in this field, was totally underestimated.

4. The EURO and the law of 'one price'

Article 109j(4) of the Treaty establishing the European Community sets out the 1st of January 1999 as the latest date for the beginning of stage III of Economic and Monetary Union, with a single currency and a single monetary policy.

In 1999, the Commission communication on the implementation of the framework for financial services, known as the Action plan[13], was the opportunity to stress that, despite the important steps taken towards the construction of the single market and the introduction of the euro, European financial markets remained segmented. Indeed, businesses and, above all, consumers continued to be deprived from direct access to cross-border financial institutions. The Commission highlighted in particular that fundamental changes in the EU financial markets were driven by wholesale services and instruments, whose price differentials dropped with the single currency while users and suppliers of retail financial services were not able to take advantage of the commercial opportunities offered by the single market. Prices of main financial assets converged significantly (e.g. Chart B), Therefore, there was a case to take initiatives for retail services, while ensuring consumer protection. Special reference was made to low value credit transfers

[11] It was then adopted as Directive 97/5 on Cross Border Credit Transfers.

[12] BERNANKE, *Clearinghouses, Financial Stability and Financial Reform, Remarks at the 2011 Financial Market Conferences,* FRBA, Georgia, April 2011.

[13] EU Commission, Financial Services, Implementing the framework for Financial Markets: Action Plan. 11 May 1999. COM (1999) 232.

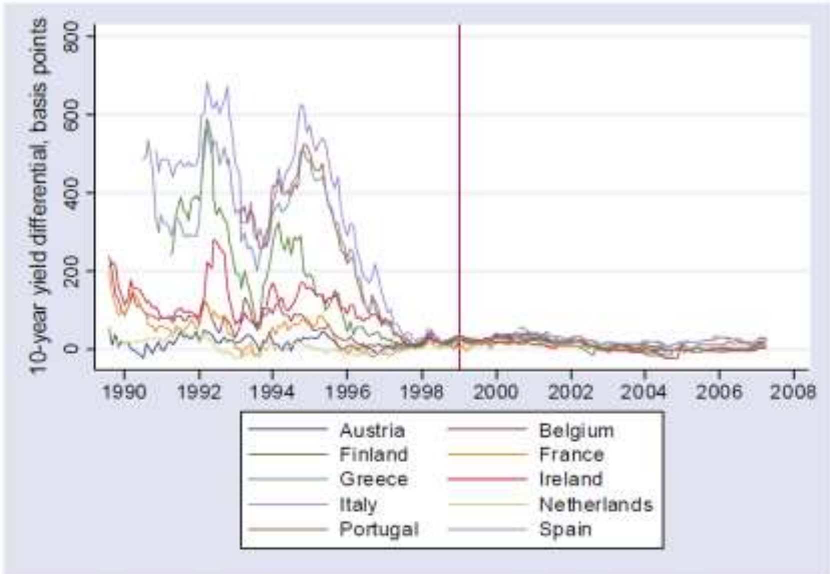
between EU countries that continued to attract very high charges. Likewise, charges for cross-border card payments were higher, and often much less transparent, than fees for domestic card payments. In 2000, another Communication[14] set the date of January 2002 as deadline to provide solutions for enhancing the efficiency of cross-border payments - by cutting charges towards the level of domestic credit transfers- and invited banks and groups of banks to put forward specific proposals in this direction. Banks were also encouraged to implement the IBAN and other technical standards, as well as ensuring interoperability for electronic means of payments. The Commission, in cooperation with the ESCB, would have assessed whether banks' proposals were satisfactory and in case solutions were not considered sufficient, it would have taken appropriate legislative initiatives to overcome the inefficiencies.

Only in 2002 with the introduction of the euro as single currency, the need to impose the "law of one price" for similar products in domestic and cross border payments was definitely clear[15]. Regulation 2560/2001 of 19 December 2001 marked a turning point in the European policy stance in promoting the internal market and was a 'slap in the face' to the EU banking community's resistance toward integration. The EC Regulation 2560/2001 established the principle of equality of charges for payments within member states (national) and across the borders. The Regulation applied to ATM cash withdrawals and purchases by payment card since July 2002 and to credit transfers since July 2003. The base principles enshrined within the Regulation were the non-discrimination between corresponding national and cross-border payments made in euro on the basis of price and the requirement on banks to provide customers with readily comprehensible ex-ante information on charges levied for affected payments.

[14] EU Commission, Communication on Retail Payments in the Internal Market. 31 January 2000. COM (2000) 36 final.

[15] Jappelli and Pagano write: «Financial markets are integrated when the law of one price holds», in JAPPELLI – PAGANO, *Financial Market Integration under EMU*, CSEF Paper n. 197, 2008.

Chart B 10-years benchmark bond yield spreads before and after the EMU. 1990-2007



Note: Yield differentials are computed relative to the yield on the benchmark German 10-year Bund, based on monthly data (end-of-month observations). Source: Datastream.

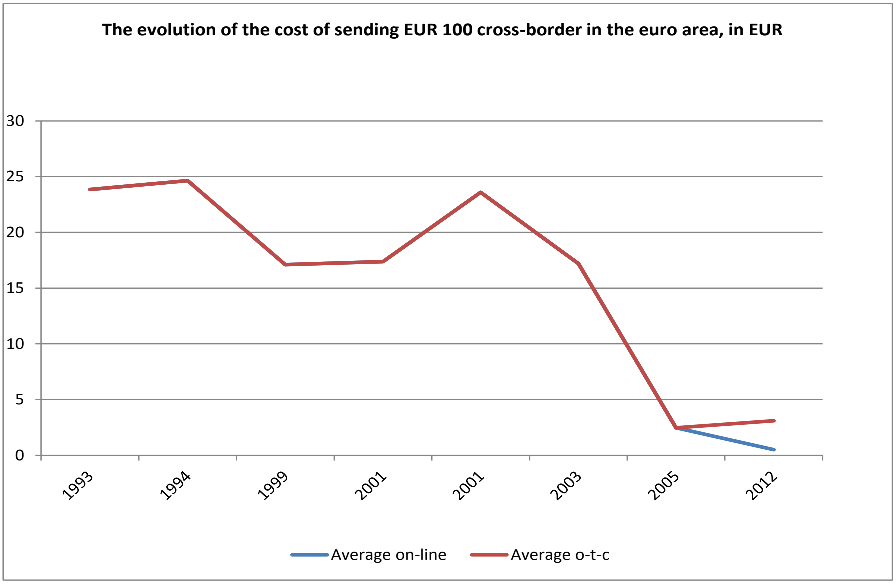
Source: Jappelli and Pagano (2008)

When it was adopted, the Regulation raised vigorous opposition from the banking sector, because of its perceived “price-fixing” nature. The main argument was that the number of cross-border payments was small (indeed it is still the 3% of the total transactions) in comparison to national payments, and that the consequence of the Regulation would be to increase national prices, which happened in some cases (e.g. LUX, BE, GR, FR, IT, SP, PT, see Table 2).

However, based on the several studies on costs of cross-border credit transfers by the European Commission, Regulation 2560/2001 was a success and finally able to reduce the price of cross-border payments (Table 3): the charges for a EUR 100 transfer costing the consumer on average EUR 24 in 1993, after the introduction of the Regulation, were dramatically reduced to less than EUR 2.00 (see Chart C).

From that period on the European institutions recognized that the integration of the payment systems in the EU would not have developed through self-regulation promoted by banks, but there was instead the need for regulatory and legislative initiatives[16]. However, outside the perimeter of the European System of Central Banks[17], the economic reasons for such a huge difference in the costs of cross-border transactions were not fully debated and the fact that payment infrastructures are a network industry based on standards, externalities and high fixed costs, was not generally understood.

Chart C – Results of the European Commission surveys on the costs of cross border transactions in internal market. 1993- 2013.



Source: European Commission (2006); London Economics (2013)

[16] Meanwhile, the Commission continued to sustain the integration of capital markets, in particular of securities clearing and settlement systems where the costs of post-trade services across border had remained high compared to domestic costs. See the two reports of the GIOVANNINI GROUP, *Cross-Border Clearing and Settlement Arrangements in the European Union*, November 2001; GIOVANNINI GROUP, *Second Report on EU Clearing and Settlement Arrangements*, April 2003.

[17] For an example of awareness, see the arguments around the role of the ECB as overseer of the payment and settlement system in European Central Bank. See: ECB, *Eurosystem oversight policy*, July 2011.

5. The age of SEPA

Retrospectively, Regulation 2560/2001 could be considered also as the kick-off of the Single Euro Payments Area (SEPA), that is the area in which consumers, companies and other economic actors can make and receive payments in euro, whether between or within national boundaries under the same basic conditions, rights and obligations, regardless of their location. For the first time, the process of integration in retail payments directly involved domestic schemes and instruments and not only cross-border transactions. In fact, the Regulation encouraged the European banking industry to create the European Payments Council (EPC) in June 2002 with the aim to define and manage an EU-wide, integrated payment infrastructure for retail payments setting open and common industry standards for core payment instruments, like credit transfers and direct debits. Self-defined standards and rules by the industry was expected to deliver the SEPA project by 2010[18].

However, and in support of the industry commitment, the European Commission intervened again to set the legal basis for the SEPA, mainly with a proposal that was finally adopted in 2007 as the Payment Services Directive (PSD)[19] implemented by all Member States by 1 November 2009. The PSD extended the idea of same rules for same payments to all electronic payment instruments in the European Union while addressing the improvement of competition, efficiency and cost-reduction, also by opening up payment markets to new entrants (payment service providers) (Table 3)[20].

According to the European Commission, a successful implementation of the SEPA project could save the EU economy between €50 and €100 billion per year[21] . From the launch of the project, the ECB has acted as a catalyst, providing analytical work and producing progress reports, together with the national central banks, as well as organising conferences and other events to bring market participants together. Nevertheless the governance of the project by the European banking industry faced several 'coordination problems',

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[18] Although related to euro denominated transactions, the single euro payments area is covering the 28 EU Member States, plus Iceland, Norway, Liechtenstein, Monaco, Switzerland and San Marino).

[19] Directive 2007/64/EC – Payment services in the internal market Directive on Payment Services (PSD).

[20] The efforts by the European Commission to cut the costs of the other components of cross-border transfers for consumer - namely on the maximum time allowed for settling a cross-border transaction and on the interbank practice of "double-charging" of fees – dated back to 1990.

[21] See: EU Commission, Time to Move Up A Gear. 2006 Annual Progress Report on Growth and Jobs at: http://europa.eu.int/growthandjobs/pdf/2006_annual_report_full_en.pdf

mainly related to the difficulties to accommodate the diverse requirements of national banking communities.

The SEPA Rulebooks set European standards for basic retail payments, i.e. SEPA credit transfers and direct debits, and helped to reach some concrete achievements:

- Pan-European schemes were introduced by the payments industry in January 2008 and November 2009 respectively;
- costs for cross-border payments are the same as for national payments;
- the execution time for a credit transfer does not take more than one banking day (D+1);
- multi-country corporates no longer need a payment service provider in each of the countries in which they are active, but have started to consolidate their handling of payment flows in euro and related treasury services, hence reducing operational complexity and increasing competition in corporate banking.

As for the payments infrastructure to handle and settle SEPA payments, the project aimed to guarantee the reachability of all European citizens with a full geographical coverage in Europe, through the creation of a PAN-European Automated Clearing House (PEACH) or the links of national ACHs. In 1992 there were about 60 EU domestic payment systems in the European Union. Banks that operate in different member states needed to adapt to those 60 different procedures and technical standards. The domestic automated clearing houses (ACHs) of the Member States did not communicate with each other and cross border transfers had to be processed through the rather time and cost-consuming channel of correspondent banking, based on bilateral relationships between financial institutions. The creation of a PEACH was sponsored by a bank-owned provider of European payment infrastructure solutions[22] while the process of consolidation among the national ACHs started – in 2014 the "SEPA compliant" ACHs are 30 -. However the market-led process of consolidation of retail payment infrastructures was very slow and different from the authority-led consolidation of large-value payment systems, which in the same years evolved and drew a second generation of

[22] The STEP2 system, managed by EBA Clearing. Indeed the system started to operate even before the definition of rulebooks. The first STEP2 service was launched in April 2003 for processing credit transfers that are compliant with the convention on credit transfers in euro, i.e. retail payments of up to 50,000 euro per transaction, in accordance with the requirements of EC Regulation 2560/2001, which was superseded by EC Regulation 924/2009.

single infrastructures (like TARGET2 which replaced the previous one in May 2008)[23].

Although fully supported by the Commission, the European Central Bank and the member states, the implementation of the SEPA project was harder than expected. The coordination problems among the European banking industry halted the speed of definition and adoption of standards for SEPA basic payment instruments (credit transfers and direct debit) and value added services and for the full interoperability of European payment infrastructures. Once again, the end-date of the project (1st August 2014), that is the final substitution of domestic procedures with the European ones, was imposed by regulations (EU Regulation 260/2012 and EU Regulation 248/2014).

6. The aftermath of 2008

At the beginning of the last decade and before 2008, in EU wholesale activities and all transactions between financial institutions presented an extremely high degree of integration. (Chart D). Spreads registered on interbank European markets became practically identical immediately after the introduction of the single currency. The payment infrastructure for wholesale payments was almost fully integrated. Moreover, bond issuances by large companies on international markets were higher than domestic issuances. Asset management activity and trading were concentrated and diversified at European and international level, thus benefiting from significant economies of scope and scale. In 2004, about 30% of the banking sector was owned by non-resident banks, with a considerable increase from the previous decade, following an intensification of mergers and acquisitions. In 2007, almost 40% of the euro area interbank claims were vis-à-vis non-domestic banks in the EU. Cross-border holdings in bond markets accounted for 54% of total holdings of EU bonds[24].

[23] Similarly to its predecessor, TARGET2 is used for the settlement of payments connected with monetary policy operations, of interbank payments and of transactions related to other payment and securities settlement systems (i.e. ancillary systems). The previuos version had a decentralised technical structure, consisting of 17 national RTGS systems and the ECB payment mechanism, and was available for credit transfers in the countries that had adopted the euro as their currency. TARGET2 offers a technically integrated platform, harmonised services at the EU level and a single pricing structure. It provides ancillary systems with a harmonised set of cash – settlement services. The new single platform was explicitly aimed to lower costs.

[24] IMF, *Financial Integration and Fragmentation in the European Union*, IMF Country Report n. 1371, March 2013.

Overall, a large European financial industry had emerged[25], also thanks to the opportunities created at the EU level, that were particularly advantageous to large companies and banks. Indeed, the integration in the euro area and in the EU advanced in wholesale funding markets and bond markets, while retail lending markets remained mostly national. The integration of EU local banking markets remained low, especially compared to what happened in the U.S. following the interstate deregulation in the 1980s[26].

The road to integration was halted by the 2008 crisis. This triggered a reversal of the integration process, reinforced by the sovereign debt crisis within the euro area and the related perverse bank-sovereign feedback loop. The result was a trend towards fragmentation and re-nationalization of the financial systems in the EU (Chart E). BIS data indicate that gross consolidated foreign claims of euro area banks decreased by 35% from 2008 and 2012, returning to the level of 2005[27].

The process of integration of payment systems slowed down considerably, together with the shrinking of payment transactions, and despite the decisive impulse provided by the legislation since the beginning of the decade[28].

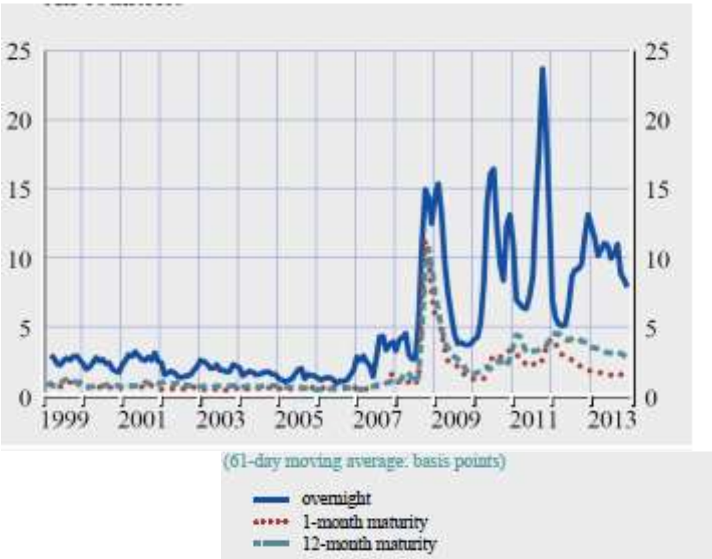
[25] PADOA SCHIOPPA, *Regulating Finance. Balancing Freedom and Risk*, Oxford University Press, 2004.

[26] IMF, *Financial Integration and Fragmentation in the European Union*, IMF Country Report n. 1371, March 2013.

[27] BOLOGNA – CACCAVAIO, *Euro Area (cross-border?) Banking*, Bank of Italy, Occasional Paper 2014.

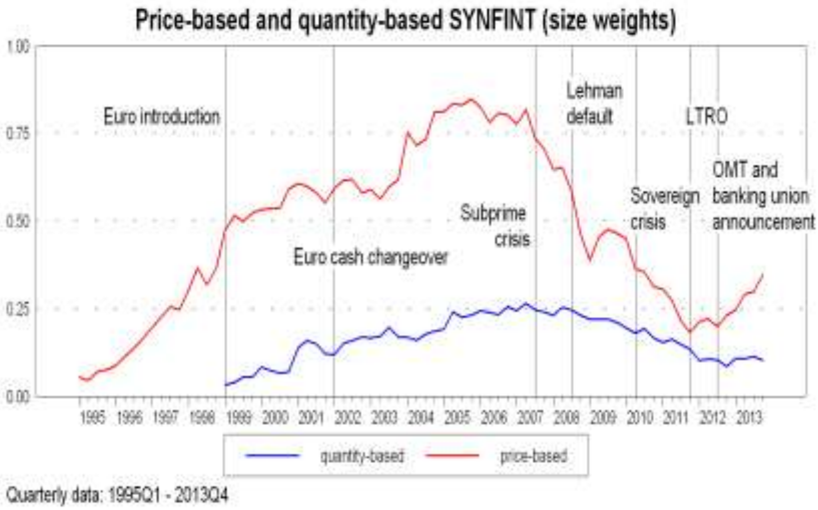
[28] PAGANO, *Dealing with Financial Crises: how much help from research?*, CSEF Working Paper n. 361, May 2014.

Chart D Cross country standard deviation of average usecured interbank lending rates (*)



(*) AT,BE,DE,ES,FI,FR,GR,IE,IT,LU,NL.PT.
Source: ECB, Financial Integration in Europe, April 2014

Chart E - Overall developments in financial integration(*)



(*) SYNFINT index with 1= full integration and 0=total fragmentation.
Source: European Central Bank (2014)

The velocity of circulation of retail transactions decreased sharply after the 2008: the value of total payment transactions that was 20 times GDP in 2008 for the EU area decreased to 18 times in 2009 and it is still at the same level; in the Euro area, the ratio was 15 times in 2008 and it is still the same now. The same ratio for large value transactions in TARGET2 (which was 75 times GDP in 2012) and in the multi-currency settlement systems of foreign exchange trades did not follow the same path, showing a decrease only in 2009. This was the occasion to start a deeper analysis of what was needed to regain momentum and also to form a critical view on the approaches by the European authorities to the payment systems integrations.

In this perspective, the aftermath of 2008 had the positive outcome of highlighting some weaknesses in the analytical background of the integration process. In fact, although market infrastructures have generally functioned well during the crises, some events, especially the default of Lehman Brothers in September 2008 and the dynamics of sovereign debt crises, showed the ‘negative’ side of integration and its potential dangerous effects on financial stability. In particular:

- a single integrated market usually has a high level of interconnection of payments, clearing and settlement systems, also through common participants or common service providers. This may produce contagion, which require a strong commitment to cooperation and information sharing also on micro-aspects, as well as common knowledge of administrative rules (i.e. default procedures) among national communities. It also requires an enhanced system of supervision;

- the coexistence of integrated areas of the economy with fragmented markets might affect financial stability. «While euro area interbank markets became almost completely integrated, retail banking integration remained largely fragmented»[29]. This meant that when the crisis hit, the cost of repairing banks' balance sheets fell largely on their domestic fiscal authorities. «The result was the infamous bank-sovereign nexus that has perpetuated financial fragmentation in the euro area»[30];
- the integration of market and payment infrastructures is not sufficient if monetary transactions (innovative payment instruments, or schemes) and new financial instruments are traded and settled off of them. Commitments were taken in this regard by the G20 at global level in 2009 and the Financial Stability Board was tasked with implementing a reform of OTC derivatives markets in order to achieve consistency across jurisdictions, avoid regulatory arbitrage and promote greater standardization of derivatives products[31];
- the lack of integrated retail payments and markets imposes higher costs on retail clients (SMEs, citizens, public administrations) than on payment service providers, which are reluctant to invest in infrastructures and innovative payment instruments.

Besides the profound institutional changes started with the design of the single supervisory mechanism, European authorities, and in particular central banks, increased the efforts to monitor and control inefficiencies in the design

[29] Financial Integration in Europe, European Central Bank, April 2008.

[30] DRAGHI, Financial Integration and Banking Union'. Speech by Mario Draghi, President of the ECB, at the conference for the 20th anniversary of the establishment of the European Monetary Institute, Brussels, 12 February 2014.

[31] FINANCIAL STABILITY BOARD, *Implementing OTC Derivatives Market Reform*, 25 October 2010. Based on a Commission proposal of 2010, the Regulation 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (also referred to as the European Market Infrastructure Regulation (EMIR)) entered into force in August 2012. Moreover, on 7 March 2012, the European Commission issued a proposal for a regulation «on improving securities settlement in the European Union and on central securities depositories (CSDs)». The Central Securities Depository Regulation (CSDR) Regulation (EU) No 909/2014, entered into force on 17 September 2014, establishes an EU framework for the authorisation, supervision, cross-border service provision and outsourcing to a public entity, as well as prudential and organisational requirements for CSDs.

of pre and post-trading infrastructures, in the allocation of costs between financial intermediaries and their clients, in the pricing or management of financial risks. Monetary authorities shared the awareness of the "robust-yet-fragile" nature of financial networks: the same features that make the system more resilient under certain conditions may function as significant sources of systemic risk and instability under another[32] .

In the retail payment systems, the catalyst role of ESCB toward the SEPA project was extended to include the promotion of electronic payments, an adequate governance of the project, efficient cooperation among authorities and transparency of the costs of payment instruments[33].

7. The integration of payment and retail banking services: the recent strategy

A new report on possible ways to enhance the single market was presented to the President of the European Commission by a task force chaired by Mario Monti in May 2010[34].

The report highlighted that the single market was at a critical juncture, facing the challenge of the reduced support for market integration and the fact that the objectives enshrined in the White Book of 1985 and in the Single Act were not achieved, particularly referring to the incomplete "welding together" of the national markets, to the missed expansion of the principles to a number of new sectors and to the unfinished work to ensure that the single market is a space of opportunity for all, including citizens, consumers and SMEs. It also stressed that corporatism and rent-seeking were still keeping domestic economies partly sheltered from the full play of the single market and from competition, preventing the needed improvements. The main conclusion was that the single market had so far been to the advantage of big businesses, but had not worked for the many and the small, i.e. citizens, consumers and SMEs. On the same lines, the so-called Lamassoure report of 2008[35] on the application of Community law concluded that «creating a single space for

[32] See ACEMOGLU – OZDAGLAR – TAHBAZ-SALEBI, *Systemic Risk and Stability in Financial Networks*, MIT Department of Economics, Working Paper Series, January 2013.

[33] For the latter, see ECB, *The Social and private costs of retail payment instruments. A European View*, Occasional Paper 2012 n. 137.

[34] MONTI, *A new strategy for the Single Market. Report to the President of the European Commission*, 9 May 2010.

[35] LAMASSOURE, *Report o "The Citizen and the Application of Community Law".Report to the President of the Republic*, 2008.

citizens is still at the stage before the Single European Act of 1986». Among a number of other recommendations to ensure a better functioning of the single market, also in the perspective of citizens, consumers and SMEs, the Monti report called for accelerating the integration of retail banking services, with a particular emphasis on retail payment services.

The new strategy of the European regulators with regard to payment providers and services developed along three lines:

- removing the obstacles to cross-border retail banking services through improved transparency of bank fees, enhancing customer mobility, reduction of the costs of bank account switching, ensuring the availability of standardised and comparable information for retail financial products and defining a number of basic banking services, affordable to all European citizens;
- acting vigorously with the power of the Competition rules - laid down in the Treaty [36]- on payment instruments, launching studies and opening cases in the area of card payments in order to avoid anti-competitive trade practices[37];
- promoting innovation in payment instruments, filling the gap created by existing innovative payments, such as mobile and digital payment services, while defining minimum security requirements.

It seems evident that EU authorities are currently aimed at playing a fully active role in the process, through legislative measures and policies, with a view to achieving concrete results in terms of efficiency for the whole economic system, while safeguarding consumer protection.

As for the cross-border retail banking services, already in 2007, the Commission conducted an in-depth investigation in the whole sector of retail banking and payments[38], which represents the most important sub-sector of

[36] Reference should be made to the Treaty on the Functioning of the European Union, Common Rules on Competition, Taxation and Approximation of Laws, Title VII, as well as to EU Commission, Regulation EC/1/2003 of 16 December 2002 on the implementation of rules laid down in articles 81 and 82 of the Treaty, 2003, particularly art. 17.

[37] An overview of such activity by the ECN Subgroup Banking and Payments within the European Competition Network in March 2012. European Competition Network (2012). The main competition concerns in the area of card payments are: the existence and the discrepancy in multilateral interchange fees across member states; the exercise of a significant market power by incumbent banks and brand owners in payment card networks; the prevailing of membership rules and governance arrangements in networks that may limit the participation of new competitors; preferential bilateral fee agreements; different classes of membership for the access to clearing houses or different national standards.

[38] EU COMMISSION, *Sector Inquiry under Article 17 of Regulation EC n. 1/2003 on retail banking (Final Report),* 31 January 2007. COM (2007) 33 final.

banking (over 50% of total EU activity). The Commission estimated that retail banking generated gross income to banks equivalent to approximately 2% of EU GDP; the inquiry showed a wide variety of profit margins, prices and selling patters between the member states, while there was instead evidence of convergence within individual states; a number of possible barriers to entry, in relation to regulatory issues or standardisation requirements for certain infrastructures; the existence of certain types of cooperation (such as the operation of platforms) could lead to collusion and limit competition. Surveys conducted in 2012, including the Eurobarometer of the European Commission[39], reached the following conclusions on payment services: most consumers tend to remain attached to their payment providers and only a low percentage (16%) had opened a new payment account in the previous years; only 3% of the respondents had opened an account cross-border, as consumers were dissuaded by unclear information, lack of clarity on their rights and complex processes; EU citizens had experienced difficulties in opening a payment account in a member state where they work, but do not have a permanent address.

The Single Market Act II[40] of the Commission dated 2012 identified, among other priorities, a legislative initiative on bank accounts aimed at giving all EU citizens access to a basic payment account, ensuring bank account fees that are transparent and comparable and making switching of bank accounts easier. The Commission issued a proposal for a Directive[41] to overcome some of these issues, which was adopted by the European Parliament and the Council in the spring 2014.

A new Commission proposal providing adjustments to the existing PSD adopted in 2007 has now the objective of modernising the existing legislative framework[42]. A further example of the new line taken by the European institutions, now aimed to promote fair pricing of most used payment instruments, is reflected in the Commission's proposed Regulation on

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[39] EU COMMISSION, *Standard Eurobarometer 78. Public Opinion in the European Union*, Autumn 2012.

[40] EU COMMISSION, *Communication from the Commission. Single Market Act. Together for new growth*, 3 October 2012. COM (2012) 573.

[41] EU COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on the compatibility of fees related to payment accounts, payment account switching and access to payment accounts with basic features*, 8 May 2013. COM (2013) 266 final.

[42] EU COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2913/36/EU and 2009/110/EC and repealing Directive 2007/64/EC*. COM (2013) 547 final.

interchange fees for card-based payment transactions[43]. Multilateral interchange fees are applied in four party card schemes to acquiring payment service providers and then passed on to merchants and consumers. As it has been assessed that such rules and practices seem to lead to inefficient pricing, fragmentation and reduced transparency, the proposal has the objective to regulate the use interchange fees more strictly, including with the capping of fees.

8. What have we learned?

Integration in payment systems is not a simple, automatic and linear process. The removal of barriers to free movements of services as the first (and, for a long time, only) approach adopted by regulators to integration for payment services, expecting competition to lead to gains in efficiency, stable economic growth and better services, belied expectations. The belief that markets were able to move towards integration autonomously via a self-regulatory process thus caused delay in the development of an EU integrated retail payment system.

Despite the ESCBs' awareness of financial risks and the European Antitrust authorities' knowledge of the relevant markets, the advent of the 'single' currency paradoxically perpetuated the illusion of an automatic convergence to the 'single' market. In the vast majority of cases, the European integration process was analysed for its positive impacts on European economies and not in terms of its costs (required investment in infrastructures, increasing coordination costs, interdependencies, new practices and standards). The European institutions intervened to speed up the process but no other correction of the market imperfections was judged necessary.

The financial crises required immediate and pragmatic adjustment both in the regulatory approach and in the economic narrative on payments infrastructures, and in particular their efficiency and reliability. Macroprudential policies to address vulnerabilities and risks in the financial markets called for deeper and more accurate analysis of single market structures, with the same objective but different tools and increased cooperation among authorities. The recent strategy of the European authorities now seems to share a common and more realistic view of the payment industry, and may well deliver a more robust integration.

[43] EU COMMISSION, *Proposal for a Regulation on interchange fees for card-based payment transactions*, 24 July 2013. COM (2013) 550 final.

Payment service infrastructures are utilities for the efficient working of the economy, but depend on standards accepted by all the stakeholders in the payment cycle and bear high fixed costs in a context where the increasing interdependency of markets and systems may affect financial stability. The market structure of the payment industry does not incentivise the incumbent payment service providers and their networks, enjoying considerable market power and 'monopolistic-like' profits, to innovate and compete.

As is already the case with the management of utilities of great public importance, payment services and payment infrastructures should be regulated by authorities, both national and European, and should be subject to appropriate technical standards. The latter need to be in line with objectives of consumer protection, including downward convergence of costs and optimization for end-users, as well as criteria to ensure security, transparency and legal clarity.

MAIN EUROPEAN LEGISLATION ON PAYMENT SERVICES

Directive 97/5/EC on cross-border credit transfers

Directive 98/26/EC– Settlement finality in payment and securities systems

Regulation (EC) No 2560/2001 – Cross-border payments in euro

Regulation (EC) No 1781/2006 – Information on the payer accompanying transfers of funds

Directive 2007/64/EC – Payment services in the internal market Directive on Payment Services (PSD)

Decision 2009/72/EC – Payment Systems Market Expert Group (PSMEG)

Directive 2009/110/EC on the business of e-money institutions

Regulation (EC) No 924/2009 – Cross-border payments in the Community

Recommendation - (COM) 2011/4977 – Access of basic payment accounts

Regulation(EU) No. 260/2012 – Technical and business requirements for credit transfers and direct debits in euro

Regulation (EU) No. 248/2014– amending Regulation (EU) No 260/2012 as regards the migration to Union-wide credit transfers and direct debits (SEPA end-date)

Directive 2014/92/EU - on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features

Table 1 - The composition of payment instruments in 2012

Country	All payments		Cash payments			
	Volume Percentage of EU27	*Value* Percentage of EU27	*Volume* Percentage of EU27	*Value* Percentage of EU27	*Volume* Percentage of all payments in each country	*Value* Percentage of all payments in each country
Denmark	1,03	0,32	0,61	0,57	37,39	2,26
Estonia	0,22	0,06	0,15	0,10	44,16	2,19
Finland	1,25	1,86	0,76	1,02	36,06	0,70
Greece	2,39	0,54	3,63	3,71	96,61	8,77
Hungary	1,46	0,77	1,71	1,00	72,79	1,64
Ireland	1,03	0,39	1,13	1,31	69,07	4,24
Italy	12,89	4,28	17,51	18,13	86,27	5,40
Latvia	0,32	0,15	0,36	0,19	67,74	1,57
Netherlands	3,55	2,55	2,12	2,53	36,95	1,26
Portugal	1,71	0,79	1,58	1,09	57,91	1,77
Romania	2,59	0,53	3,87	1,59	93,39	3,82
Spain	9,62	5,55	11,27	11,77	74,24	2,70
Sweden	2,05	0,53	1,26	1,47	38,29	3,56
Austria	2,26	1,02	2,02	2,77	52,52	3,48
Belgium	2,23	1,81	1,92	2,04	54,42	1,43
Bulgaria	0,86	0,06	1,31	0,44	94,61	9,87
Cyprus	0,17	0,18	0,21	0,22	77,35	1,53
Czech Republic	1,64	0,93	2,00	1,39	76,89	1,91
France	13,02	10,64	9,11	9,81	44,15	1,17
Germany	19,54	28,55	19,25	23,39	60,79	1,04
Lithuania	0,50	0,12	0,64	0,41	80,23	4,23
Luxemburg	0,34	0,42	0,16	0,21	29,06	0,63
Malta	0,07	0,07	0,09	0,08	82,30	1,51
Poland	5,13	2,72	6,64	3,36	79,93	1,57
Slovakia	0,80	0,51	0,97	0,60	75,91	1,52
Slovenia	0,39	0,11	0,40	0,36	64,18	4,33
UK	12,92	34,54	9,33	10,43	45,28	0,39
EU27	100,00	100,00	100,00	100,00	59,72	2,16

Source: ECB, Statistical Data Warehouse, ECB (2012)

Table 2 - Impact of Regulation 2560/01- Charges for Credit Transfers 2001/2005

Country	Evolution of charges (1)	Typical Sender charges		Observations
		2002	2005	
Austria	A	€0.00-1.20	€0.00-1.20	10-20 free transfers are typically allowed per month
Belgium	A	€0.00-0.25	€0.00-0.30	No charge for internet-based transfers
Finland	A	€0.00-4.00	€0.00-4.00	No charge for internet-based transfers
France	D	€2.30-3.50	€2.85-3.90	Increase in charges for non-electronic transfers
Germany	A	€0.00-2.00	€0.00-2.00	Service included in basic account package fee
Greece	D	Min €5.58	Min €12.00	Increase in min fee unrelated to Regulation
Ireland	A	€0.00-0.76	€0.00-0.76	Changes require approval by regulator
Italy	D	€0.25-4.00	€2.00-5.00	Average cost for internet-based transfer is €0.90
Luxembourg	B	€ 0,00	€0.00-1.50	6-12 free transfers are typically allowed per month
Netherlands	A	€ 0,00	€ 0,00	Business customers are charged
Portugal	D	€0.00-1.50	€0.00-3.50	Increase in charge for paper-based transfers
Spain	D	€2.52-28.10	€3.18-29.10 (2)	Charge proportional to value of transfers
Denmark	D	€0.25-2.00	€0.25-2.00	Euro transfers incur a higher fee (€5-6)
Sweden	A	€0.00-1.65	€0.00-1.65	Euro transfers incur a slightly higher fee (ca. €0,33)
UK	A	€ 0,00	€ 0,00	Euro transfers incur a much higher fee (€26-36)

Key:

A - No charge before Regulation, no charge after Regulation

B - No charge before Regulation, charge after Regulation

C - Charge before Regulation, no charge after Regulation

D - Charge before Regulation, charge after Regulation

Notes:

(1) - Based on charges most commonly levied

(2) - Average charge for €500 and €10.000 transaction in December 2004

Source : European Commission - Retali Banking Research Ltd, London, Sept. 2005.

Table 3 - Comparison of charges of cross-border payments- 1993- 2012

The evolution of the charges of transferring EUR 100 cross-border, in EUR									
	Study	**Study**	**Study**	**Study**	**Study**	**Study**	**Study**	**Study**	
	1993	**1994**	**1999**	**2001 (1)**	**2001 (1)**	**2003**	**2005**	**2012**	
								on.line	o-t-c
Austria	-	-	10,61	17,4	22,27	11,19	0,6	0,11	0,89
Belgium	23,93	23,06	13,37	11,87	12,84	14,26	0,15	0,5	0,52
Finland	-	-	20,11	14,36	21,26	18,71	2	0	2,7
France	34,79	33,01	16,88	18,06	25,41	22,62	3,4	0,29	3,44
Germany	19,57	26,16	13,78	11,93	14,73	10,56	1	0,01	0,43
Greece	27,23	32,78	-	-	47,33	31,09	12	0,53	11,75
Ireland	23,04	27,13	25,98	25,04	36,08	22,24	0,38	0,11	0,44
Italy	19,79	20,88	18,28	19,74	28,61	16,71	3,5	1,39	3,67
Luxemburg	16,84	15,75	8,91	9,58	9,79	9,89	0,75	0,17	1,2
Netherlands	17,69	18,84	10	11,45	12,11	11,11	0	0	6
Portugal	34,37	26,75	29,68	31,04	28,08	18,12	1,75	0,42	3,26
Spain	21,1	22,04	20,5	20,56	24,65	19,78	4	2,45	2,93
Average	**23,84**	**24,64**	**17,1**	**17,37**	**23,6**	**17,19**	**2,46**	**0,50**	**3,1**

(1) Results of two studies for 2001: the first are based on a sample of 352 and the second on a sample of 1480.

Source: European Commission (2006) Staff Working Paper on the impact of Regulation EC No 2560/2001 on bank charges and national payments; London Economics (2013).

Table 4 – The legal cornerstone of SEPA

	Currencies	***Geographical Area***	***Scope***
Regulation 2560/01 Regualtion 924/2009	Euro and Swedish kronor*, optional for other EU currencies idem	EU 15 EU 12, EEA 3 (for euro and SEK payments) idem	Credit transfers, card payments, ATM withdrawals Direct debits
PSD	All EU currencies	EU 27 Possibly EEA 3 (pending the decision of the EEA Joint Committee)	General purpose – electronic payments
SEPA	Euro	EU 15 EU 12, EEA 3, EFTA 1 (for euro payments)	Credit transfers, direct debits, card payments

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