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# ECRI POLICY BRIEF

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## *One step closer to harmonised European payment systems*

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**A** consensus has been reached by the European Parliament in favour of the proposed Payment Services Directive (PSD), and the proposed legislation is due to be adopted shortly by the EU Council, following two years of intensive negotiations. The proposed directive is an ambitious effort to create a single EU-wide market for electronic (cashless) payments, in particular credit transfers, direct debit and card payments. With a common set of rules applicable to all payment services in the Union, it is intended to make cross-border payments between member states as easy and efficient as national transactions. The proposed Directive seeks to simultaneously enhance product quality and reduce costs by opening the payments market to new entrants, including non-bank institutions. Further intensification of competition will benefit consumers and banks as well as various other stakeholders. It is also seen as the foundation of the Single European Payments Area which is to be launched by 1 January 2008. Pending the formal adoption by the Council, member states are to implement the Directive no later than 1 November 2009.

The Financial Services Action Plan (FSAP) – encompassing more than 40 measures aimed at achieving greater integration of financial services across the EU – has not yet had a major impact on payment systems. This is not surprising, given that the integration of some of these services, such as retail banking or mortgages, has also not lived up to the expectations invested in them. Seven years after the Lisbon Council adopted the FSAP to harmonise existing regulations, national rules are still heavily fragmented across the EU member states, especially in the case of payment services. Currently, there are geographical boundaries of existing payment services due to high transactions costs, which seriously hamper or even prevent cross-border trade. In order to secure the EU economy's growth potential and competitiveness, there is an urgent need to focus attention on financial services. Taking into consideration that payment transactions amounting to €52 trillion in total value are currently being carried out in the EU each year, the Directive tackles a market with great savings potential for the EU. These savings are estimated to be at least as high as €50 billion per year for the EU economy. With the Payment Services Directive, the European Commission aims to address issues of market inefficiencies, lack of competition and perceived stagnating product quality.

It is anticipated that the introduction of a simplified and harmonised set of legal standards will bring greater national and cross-border competition, because it paves the way for a level playing field and allows a new generation of (non-banking) financial service providers to enter the market. Furthermore, clarity with regard to the players' rights and obligations is vital for the smooth functioning of the financial market. The PSD spells out both the players' rights and obligations and the objective of increased market transparency for providers and users. The Directive explicitly focuses on non-cash payments: the Commission estimates that a reduction of expensive cash transactions (amounting to 60-70% of the total cost of the payment system) in favour of greater use of more cost-efficient electronic services would substantially cut overall costs, and thus stimulate consumer spending and economic growth.

### ***THE PROBLEM: MARKET FRAGMENTATION ALONG NATIONAL BORDERS***

Divergent legal settings in the 27 member states not only introduce price rigidities and (unjustifiable) differences into national payment services, but they also create significant impediments for players who are interested in offering their services across member states. The same holds for potential new entrants to the market for payment services – such as supermarkets, telecommunications providers and other non-bank institutions.

Differences in the price and quality of services are understood to be an indicator of efficiency discrepancies and market fragmentation along national lines. Studies by the European Commission reveal that differences in prices for payment services are currently as high as a factor of 1:8, with Italy and Germany leading the list of the EU countries with the most expensive services. Merchant fees in the range of 2.5% to 3.1% in Portugal, Czech Republic and Hungary are substantially higher than in Sweden and Finland, where only one-third or a quarter of that amount is charged. The results do not seem to be much different when analysing cardholder fees: while fee discrepancies between the two main credit card brands within a country are small, the opposite is true for the cross-border comparison. A large amount of countries are situated above the international average fee of €23 and €24 for MasterCard and Visa, respectively.

Highly divergent fees charged for the issuing of a credit card are an indicator of a lack of competition. It is important to note that significant discrepancies in prices still exist even if national peculiarities and historical developments are accounted for. Studies such as Kleimeier & Sander<sup>1</sup> show that prices will eventually converge following further integration of the market, although they may never become fully equal, as might be assumed by the 'law of one price'. Additional evidence of market concentration can be found in the high profitability of issuing cards, where an average profit-to-cost ratio of 65% for credit cards and 47% for debit cards can be observed.

Systems dominated by highly vertically integrated players as well as joint ventures between local banks impose structural barriers and effectively impede intensity of competition that would be necessary to move towards greater cost-efficiency. While the markets in Spain and Portugal still feature a highly integrated supply side, the Netherlands successfully de-integrated its system, resulting in lower merchant fees. Technical incompatibility of national standards is a major obstacle to players wishing to offer services across European markets. Further, there are behavioural barriers. For instance, market incumbents agree to create artificially large differentials in interchange fees in order to make market entry of foreign banks more expensive and difficult. According to the Commission, this tactic seems to be employed in Austria and Portugal.

<sup>1</sup> Stefanie Kleimeier and Harald Sander, *Consumer Credit Rates in the Eurozone: Evidence on the Emergence on a Single Retail Banking Market*, ECRI Research Report No. 2, January 2002.

Similarly, the refusal of established players to grant access to clearing facilities for potential new entrants, thereby preventing the rise of new competitors constitutes a barrier to the market, foremost in the UK, Finland and Ireland. A market analysis of one part of the payment system – the acquisition of credit cards – by means of the Herfindahl-Hirschmann Index showed significant signs of market concentration. The index is based on squaring and adding up the players' market shares. Results below 1,000 points indicate low concentration, whereas markets with more than 2,000 points are considered to be concentrated. This index is below 2,000 only for Spain, while results of over 8.000 points are found for a number of EU countries, justifying the PSD's drive for improved competition.

### ***NETWORK ECONOMICS AND PAYMENT SYSTEMS***

From the standpoint of economic theory, the existing problems can be traced back to features of payment system markets that are closely related to those of network industries. Networks consist of compatible nodes and links and are subject in most cases to critical mass phenomena, path dependency, economies of scale and scope, lock-in and non-linear growth. An understanding of the peculiarities of network economics is crucial in order to analyse the industrial organisation and functioning of the payment system market. For instance, economies of scale and scope as well as non-linear growth typically lead to highly concentrated industry structures. Compatibility, on the other hand, can in many cases only be reached by cooperation among competitors. Thus, it is important to point out that some cooperation in terms of payment systems infrastructure and standards needs to be accepted in order to ensure the smooth functioning of a single financial market.

In fact, studies show that the underlying network effects keep competition within limits, as necessary economies of scale and critical mass requirements cannot be achieved without some cooperation. But there are other reasons for the current fragmentation along national lines. For instance, costs or technical incompatibility as well as the (still) low demand for international transactions reduce the incentive to invest across borders. In the case of low demand for international transactions, the necessary economies of scale are not reached to justify the expense.

Consumers, on the other hand, are typically characterized by inertia and will not demand new payment instruments if the number of consumers of the new product is not sufficiently high. These so-called 'demand-side' economies of scale (or network effects) signify that an increasing number of users of a certain product (such as a new payment service) will directly increase the utility of other consumers of the same service. In addition, switching seems to generate unreasonably high financial and non-financial costs. Switching costs lock the consumer into the existing (national) system and generate market power for the incumbent on the supply side as prices can theoretically be raised by the amount of switching costs. One of the main questions is whether providers have an incentive to act as first mover in building a pan-European network or if the risk of sunk costs leads to a deadlock situation where systems remain fragmented. If the benefits of the PSD are to be successfully reaped, regulation needs to carefully address network economic issues.

### ***TACKLING THE PROBLEMS WITH DEREGULATION***

The main strategic objectives of the PSD are three-fold. First, by removing legal barriers, it is intended to create a level playing field for payment service providers, including non-bank institutions. This increases the number of providers that are in direct competition with each other. A further intention is to reduce the number of actual payment infrastructures, thereby encouraging the established players to lower prices in order to successfully compete for customers and reducing possible customer lock-in and market power. In addition, competition is one of the main drivers for efficiency and – highly correlated – (cost-cutting) innovation. Progressive improvement of existing systems will lead to reduced processing costs, allowing payment services providers to further lower charged fees.

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Non-financial aspects also need to be considered: processing time and security matters as well as general consumer convenience and service quality which depend on the willingness of/and incentives given to the supply side to innovate. Secondly, by increasing market transparency for providers and users, standardised conditions for payment services will allow consumers to faster calculate and compare services offered in the market. On the so-called ‘D+1’ basis, for example, the service provider is obliged to execute transactions without currency conversion by the end of the next business day. Furthermore, the ‘full amount principle’ requires that the full amount stated in the transaction be credited without any kind of deduction. Providers, on the other hand, will be able to profit from the possibility to enter foreign markets and offer their services, being subject to the same set of information requirements existing in their home market. This will create a more efficient and wider European payment services market.

Thirdly, in order to tackle national fragmentation of markets and to reduce protection of national markets from outside competition, a standardised set of rights and obligations of providers and users is to be introduced. With the aim of providing a high level of consumer protection, 27 national rules will be replaced by one set of legal standards on which consumers and providers can rely when demanding or supplying payment services. Alongside these objectives, the PSD supports the creation of the SEPA (Single European Payment Area), laying the necessary legal foundation and encouraging the European banking industry to deepen its efforts and complete its work in this self-regulatory industry initiative. SEPA, which is overseen by the European Payments Council, is intended to allow citizens to make payments in euro within Europe, whether between or within the national boundaries under the same basic conditions, rights and obligations.

Among the most contentious issues, however, are the minimum capital requirements imposed on the new generation of payment services providers, the so-called non-bank ‘payment institutions’. To avoid overburdening these potential market entrants, less stringent supervision and regulation are to be applied. The European Commission states that smaller capital requirements for (small) payment institutions are necessary, accounting for the differences in the business models and the risks between banks and other payment service providers. The PSD gives the authorities of the member states the choice between three different methods of calculating the minimum capital requirements, allowing them to increase or reduce these requirements by 20%, depending on the quality of the payment institution’s risk management. However, the gap between the minimum levels of required initial capital is substantial: €5 million for banks vs. a mere €20,000 for new payment institutions.

### ***THE NEXT BIG CHALLENGE***

Two years of intensive negotiations have ended with the adoption of the Payment Services Directive by the European Parliament in the first reading. The process to create an integrated single market in financial services is therefore one step closer to implementation. Before being transposed into national law by the Member States, it now needs to be formally adopted by the Council. Although the matter is highly technical and complex, there seems to be the political agreement that payment services must be integrated in Europe. This is important for an efficient functioning of financial services. In addition, competitive disadvantages through regulations should disappear so that there is a level playing field for competitors.

The consensus reached on the PSD is a major step towards more harmonised payment systems in Europe. Although, there is a broad consensus about the possible benefits, the next big challenge will be the implementation. Also in the future, however, preserving competition in the area of payment systems will be an ongoing effort as the peculiarities of network features induce concentration. Nevertheless, a level playing field might attract a higher number of players, and in the best-case scenario, it will create a truly pan-European market.



## European Credit Research Institute

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