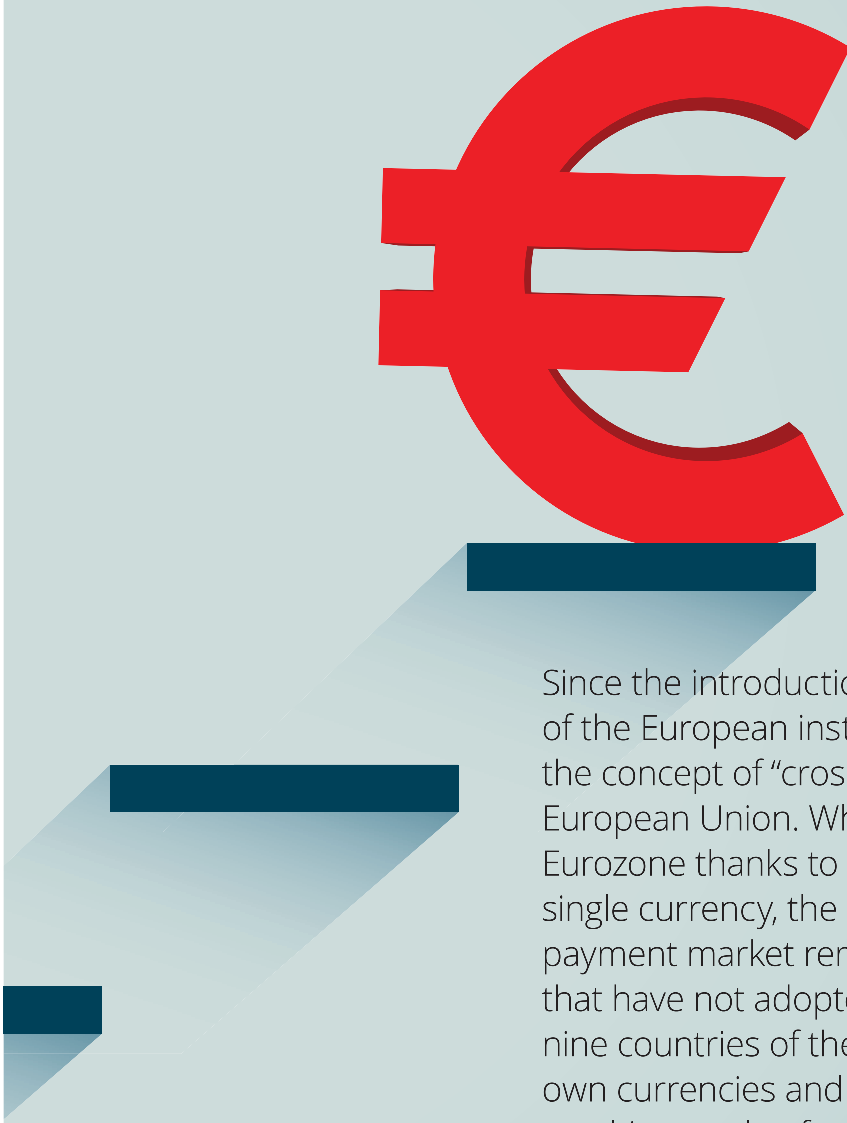
EU cross-border payments
An evolving concept

Petra Hazenberg
Partner
Strategy Regulatory
& Corporate Finance
Deloitte

Jordan Cattaruzza
Analyst
Operations Excellence
& Human Capital
Deloitte

Fabrizio Dicembre
Director
Strategy, Regulatory
& Corporate Finance
Deloitte



Since the introduction of the euro, a major ambition of the European institutions has been to eradicate the concept of "cross-border payments" within the European Union. While this has been done in the Eurozone thanks to the introduction of the euro as a single currency, the development of a fully integrated payment market remains a challenge in the countries that have not adopted the single currency. Indeed, today, nine countries of the European Union still have their own currencies and domestic payment systems. The resulting market fragmentation leads to higher costs for consumers and for banks. This article discusses the impact this has on the European Union payment market. Out of the nine, Sweden is an exceptional case, as it has adopted the regulation while keeping its own currency. Is Sweden an early example of what the European Commission is hoping to achieve as it acts to eliminate the concept of cross-border payments in a unified market?

Despite the EU's efforts, the concept of domestic versus cross-border payments is still present in the European Union.

The European single market
Since its construction, the European Union has devised and implemented multiple initiatives aimed at achieving one of its ultimate goals: creating a single EU territory devoid of borders and regulatory hurdles. This concept, known as the European single market, guarantees the free movement of goods, capital, services, and labor to more than 500 million customers in all participating states. It is argued that developing an integrated market within the EU would help to deliver real improvements to people's lives in the EU by enabling companies to offer their services throughout the block, improving choice and lowering prices for consumers, as well as fostering competition and innovation.

The European Commission is taking the same approach when it comes to the financial market, including payment and retail financial services.

The fragmented EU payment market
Despite the efforts made by the European Commission to integrate the payment market in the European Union, the concept of domestic versus cross-border transactions is still present today. Indeed, **the market is segregated into three groups of actors:**

01. 19 countries in the Eurozone have integrated payment systems within which the notion of "cross-border payments" no longer exists
02. 8 countries of the European Union have kept their domestic currencies, meaning that payment systems are not integrated or standardized (Box 1) and the notion of "cross-border payments" still exists
03. 1 country (Sweden) still has its local currency but has adopted European cross-border rules, meaning that the notion of "cross-border payment" with Eurozone countries no longer exists

Box 1: Illustration of lack of harmonization in the European payment market—Clearing system operating hours
The table below shows the operating hours (GMT+1) of the clearing systems in Europe, demonstrating that the operating hours of the various clearing systems have not been harmonized across European Union countries. As a consequence, it is possible that a payment processed at the same time in two different currencies will be received by the beneficiary on different business days. This example illustrates the lack of harmonization in the European payment market and represents a difficulty European authorities must overcome if they are to implement a single European payment system.

Country	Clearing house	Currency	System	Operating hours (for consumers)	Operating hours (for interbank)
Eurozone countries	TARGET2	EUR	RTGS	7 a.m. – 5 p.m.	7 a.m. – 6 p.m.
Bulgaria	RINGS	BGN	RTGS	7 a.m. – 2.45 p.m.	7 a.m. – 2.45 p.m.
Croatia	CLVPS	HRK	RTGS	7.30 p.m. – 6 p.m.	7.30 p.m. – 6 p.m.
Czech Republic	CERTIS	CZK	RTGS	12 p.m. – 4 p.m.	12 p.m. – 4 p.m.
Denmark	KRONOS	DKK	RTGS	n/a	7 a.m. – 3.30 p.m.
Poland	SORBNET	PLN	RTGS	7 a.m. – 5 p.m.	7 a.m. – 6 p.m.
Hungary	VIBER	HUF	RTGS	7 a.m. – 5 p.m.	7 a.m. – 6 p.m.
Romania	REGIS	LEI	RTGS	7 a.m. – 4 p.m.	7 a.m. – 4 p.m.
Sweden	RIX	SEK	RTGS	8 a.m. – 5 p.m.	8 a.m. – 5 p.m.
UK	CHAPS	GBP	RTGS	7 a.m. – 7 p.m.	7 a.m. – 7 p.m.

The expensive charges for cross-border transactions outside of the Eurozone

As the notion of "cross-border transactions" no longer exists within Eurozone countries, the fees charged to consumers for euro payments in the Eurozone have decreased to a few cents. However, this is not the case for consumers from other EU member states in which the notion of "cross-border payments" still exists. Indeed, in these countries, **the fees for cross-border transactions in euro are well above the level of fees payed for national transfers in the local currency.** Figure 1 provides an extract of Deloitte's study on the fees charged by banks to consumers. This illustrates, for Deloitte's sample, the lowest and highest fees charged by banks to a consumer in Croatia (an EU non-euro country) for a domestic local-currency transaction and for a euro cross-border transaction.

High fees also apply for consumers in EU countries (i.e., Eurozone and non-Eurozone) who want to transfer credit in the currency of an EU member state other than the euro. Figure 2 illustrates an example, from Deloitte's study, of the transaction price charged by a bank to a consumer in France (an EU country) both for a domestic local-currency transaction and for a non-euro cross-border transaction.

The high fees charged for cross-border transactions are one of the main complaints consumers have with regards to payments in the European Union. This hinders the free movement of goods in the European Union and discourages small and medium-sized enterprises from operating in the various countries of the European Union. Consequently, consumers favor large and rare payments or increasingly turn to online payment service providers that can offer cheaper alternatives for cross-border payments.

The bank costs behind the fees

Euro transactions

Eurozone banks are able to offer low prices for euro transactions because processing these payments is fairly inexpensive for them. Indeed, processing euro transactions is lean and efficient due to the vast volumes processed and the simplicity of the models: single format, single clearing system, and certainty of time and costs. In addition, straight-through processing (i.e., a processing system that allows information to be transmitted between parties electronically) and access to a common European processing platform (TARGET2) considerably reduce the complexity for banks when processing these payments. These developments have significantly reduced the typical costs in relation to transactions, enabling banks to offer higher discounts to their clients.

Cross-border non-euro transactions

While the fees charged for euro transactions in the Eurozone are low, banks are now facing growing pressure to decrease their prices for cross-border non-euro transactions in the European Union as a consequence of the emergence of cheaper online payment service providers, consumer complaints, and the intervention of European institutions. This poses a serious challenge for banks as the cost per transaction for processing payments in non-euro currencies is high. Indeed, processing payments in these currencies requires manual intervention to account for various local specificities such as discrepancies in payment information format, different settlement procedures, and inconsistent regulations related to AML and KYC. In addition, while banks can easily process payments in euro thanks to the European payment platform TARGET2, no such common platform exists for non-euro currencies. Processing these currencies requires the intervention of a correspondent bank, which is a partner bank that has the capabilities to process local transactions by having access to local clearing systems. As illustrated in figure 3, transferring a payment in an EU non-euro currency involves more actors than a payment in euro and therefore increases the overall cost.

Figure 1: Illustrative customer fee for transferring €10 equivalent from Croatia to Croatia in Kuna and €10 to France

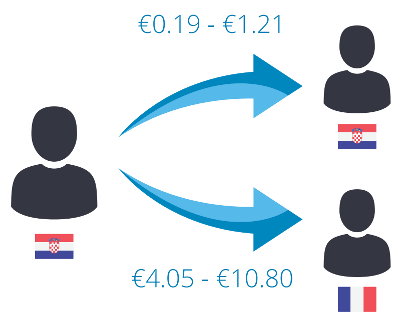


Figure 2: Illustrative customer fee for transferring €10 from France to France in Euro and €10 equivalent in Kuna to Croatia

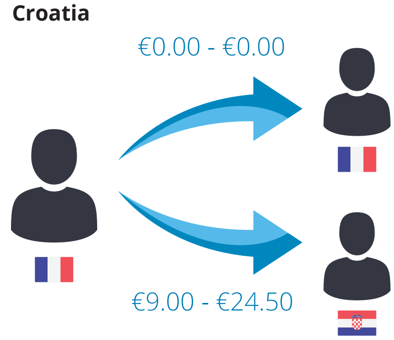
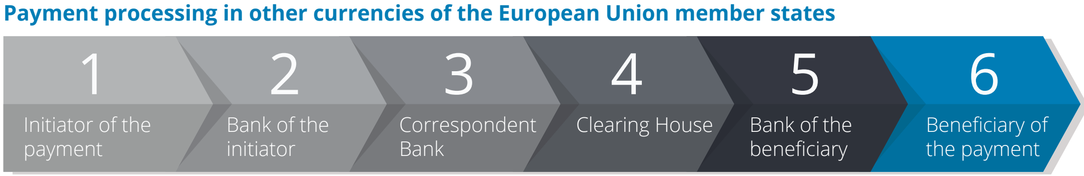


Figure 3: Intermediaries involved in a payment transaction

Payment processing in euro

Payment processing in other currencies of the European Union member states



Processing payments in non-euro currencies is approximately 40 times costlier for Eurozone banks than processing a euro credit transfer executed on TARGET2.

From Deloitte's interviews with European banks, it appears that most banks prefer to use a correspondent banking system rather than requesting access to the local clearing system, which can be complex and very costly on a per-transaction basis. Indeed, the number of cross-border transactions in EU non-euro currencies is marginal for banks. In 2015, cross-border transactions accounted for around 2 percent of total transactions in the EU[1]. In addition, from Deloitte's study sample, it appears that less than 1 percent of the retail cross-border transfers processed by Eurozone banks are cross-border transactions in an EU non-euro currency.

Overall, in comparison to euro payments, lower levels of automation and the extra players involved in processing payments in non-euro currencies lead to a transaction cost for banks that is, according to interviewed banks, approximately 40 times higher than a euro credit transfer executed on TARGET2. While automating the clearing of these currencies would reduce the costs per transaction for banks, the investments needed for such automation are not justified due to the marginal volume of transactions processed in these currencies by Eurozone banks.

1 Data retrieved in July 2017 from European Central Bank statistics.

What to expect

To respond to the issues outlined above, the European Commission is looking at a range of possible solutions. In this context, the European Commission has announced, as part of the Regulatory Fitness program (REFIT), its plan to review Regulation 924/2009.

This aims to reduce the fees charged for cross-border transactions in EU non-euro currencies and in euro initiated from EU non-euro countries. This would improve consumers' experience by decreasing fees and offering more choice as well as fostering competition among retail payment providers.

The European Commission has announced that several options could be considered for extending the regulation. Based on this declaration, Deloitte has performed a study that considers the impact for banks and consumers according to the various extension options.

Option 1: Align cross-border and domestic local-currency transaction prices

The first option is to require banks to charge similar fees for all transactions in the European Union. In this context, a bank's customer would pay the same price for a domestic local-currency or a cross-border transaction in a currency of another EU member state.

The advantages

This option would have the advantage of positively benefiting consumers and small and medium-sized businesses, as this would lower the fees for cross-border transactions throughout the European Union.

In addition, owing to single tariffs for different transactions, this would make the fees charged by banks more transparent and improve consumers' trust in the financial system.

The challenges

While this option has several advantages, such an extension would have a significant impact on banks' profits. Based on current conditions, processing these currencies is expensive for banks as it requires manual intervention. Due to the low number of transactions processed in these currencies, the investments needed to automate the processes are not justified. To make such an extension of Regulation 924/2009 viable, European institutions and central banks would need to set up a central multi-currency infrastructure that would allow banks to benefit from an integrated and less costly system.

Option 2: Align cross-border euro transaction prices with domestic local-currency transaction prices

A second option is to require banks to align cross-border euro transaction prices with domestic local-currency transaction prices. This already applies in Sweden, where the notion of "cross-border payments" with Eurozone countries has been eradicated. Indeed, in 2002, the government notified the European Commission that it would apply equal charges for domestic payments in Swedish krona and cross-border payments in euro. The Swedish Ministry of Finance argued that this regulation extension would favor Swedish integration into the European Union as well as putting pressure on the Swedish banks to develop payment functions that are competitive and automated.

The advantages

This option would make all transactions in euro less expensive for consumers, which would mostly favor non-Eurozone bank customers, who are currently charged high fees for such transactions.

While the vast majority of EU payments are already in euro, this regulation extension could further increase the number and volumes of euro transactions; further strengthening the euro as a pivotal currency of the European Union.

The challenges

As for option 1, extending Regulation 924/2009 by implementing this option would negatively affect non-Eurozone banks' profitability.

In order to limit this negative effect, European institutions would have to ensure that EU non-Eurozone are also granted . equal access to euro clearing systems such as TARGET2. Today, not all central banks in the EU have access to TARGET2, which would enable them to benefit from STP processing and therefore to have lower operations costs. The European Central Bank offers two pricing schemes for using TARGET2:

- Option A: €0.80 flat fee per transaction on top of a monthly fee of €150
- Option B: Volume-based transaction fee ranging from €0.60 to €0.125 per transaction on top of a €1,875 monthly fee

To lower their fees, banks could also use a sub-participation agreement rather than direct access. Furthermore, if we consider the ownership structure of the market leaders in the non-euro area, most of the banks are part of groups of banks with headquarters in the Eurozone, reinforcing the option of easy and economical access to those platforms. In addition, the increase in the number and volume of transactions following the adoption of the regulation would help banks to mitigate the negative impact on their profits per transaction.

Conclusion

It is apparent today that the European Union is acting to further integrate the various markets and industries to improve consumers' satisfaction and strengthen the European Union's image as a single market. Concerning the payment, the challenge for European institutions is to adopt new regulations that will enhance citizens' experience without affecting banks' profitability. A potential option for European institutions is to extend Regulation 924/2009 as per option 2, which would force banks to align cross-border euro transaction prices with domestic local-currency payment fees. If EU non-Eurozone banks are granted equal access to euro clearing systems, this would limit the impact on banks' profitability and would have the advantage of lowering cross-border fees, encouraging consumers to buy more products abroad, therefore offering them greater choice, better quality, with lower prices.

Possible extensions of Regulation 924/2009

1. Align cross-border and domestic local-currency transaction prices

Pros:

- Fee reduction for a large number of customers
- Increased transparency in banks' fee schemes

Cons:

- Large impact on banks' profits
- No current central multi-currency payment infrastructure

2. Align cross-border euro transaction prices with domestic local-currency transaction prices

Pros:

- Fee reduction for customers of non-Eurozone banks
- Large volumes of euro transactions initiated from non-Eurozone EU countries
- Strengthening of the euro as central currency of the European Union

Cons:

- Fees for domestic euro and cross-border non-euro transactions are not aligned
- Access to TARGET2 is not mandatory for central banks of non-Eurozone countries