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SEPA INCENTIVES:

Feedback to the European Commission upon the Consultative Paper

BY

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unites professionals

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INTRODUCTION

The European Security Transport Association (ESTA) is the representative body for the Cash Logistics Industry in Europe. ESTA's members transport, process, authenticate and securely store cash upon behalf of financial institutions and retailers throughout Europe.

ESTA is very pleased to have this opportunity to input into the European Commission's thinking upon the development of the Single European Payment Area (SEPA).

As requested in the Consultative Paper issued by the Commission on the 13th of February 2006, ESTA has provided feedback to the specific questions raised by the Commission where it believes its input is relevant and appropriate. In addition ESTA has also attached a more detailed document "*Cash Substitution: Issues and Implications*" that more fully explores the arguments and concepts behind its thinking in this area. ESTA believes profoundly that the issues raised in these documents need to be explored in greater detail, and therefore to support such a debate ESTA has commissioned the respected independent economic think-tank "European Economics" to examine this area. Upon completion, ESTA will be happy to share the full contents of the European Economics paper with the Commission.

QUESTIONS & RESPONSES

Question 1 *Do stakeholders have any comments on the vision in Section 2?*

As an association of European businesses, ESTA is keen for its members to benefit from a dynamically growing European economy with best of breed products and services competing within neutral and efficient markets. ESTA is therefore broadly supportive of the main aims of the Commission with respect to creating SEPA.

There are however some areas that ESTA believes need to be re-evaluated and modified if the benefits of SEPA are to be delivered for the public.

Specifically, ESTA would invite the Commission to consider cash and cheques separately as they are actually quite dissimilar instruments with dissimilar costs: a cheque is a form of instruction to a commercial bank, while cash is a token of value issued and under-written by the State that generates an income for the State.

Most academic studies undertaken have found that instruments such as cheques and paper-based Giros have high costs to the banking sector, while also finding that ATM supplied cash is relatively low cost. ESTA is concerned that by considering cheques and cash as a single entity the Commission may therefore be understating the savings achievable from the elimination of cheques while mistakenly targeting cash. For these reasons ESTA believes it would be helpful if the Commission was to disaggregate the estimated expected savings and publish both the individual estimates and the supporting material for such forecasts to all stakeholders.

Furthermore, the current SEPA vision seems to imply that any migration from cash to cards will inevitably result in a reduction of the cost of payments to banks and retailers.

The latest central-bank lead research from both The Netherlands (DNB) and Belgium (NBB) casts serious doubt upon such a view: these researchers (and others) identify credit cards as the most costly form of payment instrument.

In addition the DNB and NBB lead research shows that for there to be significant impact, there would need to be a massive uptake of e_purse payments to substitute for the lowest value payments where cash currently dominates. Today cash continues to be by far the most popular form of payment in transactional volume terms, despite several launches (and withdrawals) of e_purse schemes in various Member States. Based upon the research from the DNB and NBB, ESTA is concerned that the current SEPA vision can only achieve savings if consumers follow a single optimistic scenario: consumers migrate their lowest value payments to e_purse, while their higher value cash payments migrate to debit cards. Other less optimistic scenarios can be readily considered where consumers are much less selective about their use of cards, and some low value payments could be substituted by debit card rather than e_purse, and / or credit cards are used on occasion instead of debit cards. It is quite feasible in such circumstances that cash substitution could actually result in INCREASED costs for banks and retailers.

However such an outcome could actually be more profitable for the banks.

ESTA also believes that the fiscal impact upon the Member States of a substantial “repositioning” of cash must also be considered. ESTA estimates that for the EU15 in 2003, cash issue generated between €10.2bn & €15.8Bn in Seignorage revenues. The latter figure is equivalent to 13% of the EU2006 budget. Given that ESTA shares the Commission’s view that wider public consultation upon SEPA is essential, ESTA believes it is important that these State revenue reductions are accurately forecast, and the sources of replacement revenue specifically identified prior to such consultation commencing.

In fact ESTA believes that too narrow a view of “cost” is being taken by the EPC and others. The Commission’s definition for “best-of-breed” products is much broader:

“Best of breed means the economically most efficient product/service design taking into account all stakeholders' cost and benefits and also future development needs.”

It is clear to ESTA from this definition that the €16Bn or so of Seignorage revenue that cash issue generates for the Member States must be considered as a benefit to society and included within any best of breed assessment. ESTA has developed the concept of the “Net Societal Cost of Cash” to reflect the full “cost / benefit to society as a whole” of payment instruments. Using the recently published DNB data, ESTA can demonstrate that cash is the current best of breed payment product, as all other forms of substitute actually have a negative impact upon society as a whole (negative Net Societal Cost). In particular, when considering increased usage of credit cards, the Commission should bear in mind the impact on the level of personal debt in the EU as well as the tendency of credit cards to distribute resources from the less-well-off (who usually pay interest charges servicing their debt) to the well-off (who pay their bills in full on time and receive ‘rewards’).

In general ESTA is concerned that a reduction in the costs to the banking industry is, within some quarters, being equated with an inevitable gain for society as a whole. ESTA would caution that such a view must be rigorously examined and verified if SEPA is to actually benefit the European public at large.

ESTA’s vision of SEPA is a pan-European marketplace within which all instruments can openly compete on a level playing field with the principle of neutrality of means at the core of any (self) regulation applied.

These issues and their academic foundations are explored in more detail in the attached ESTA document “*Cash Substitution: Issues & Implications*” together with ESTA’s vision for a new efficient “Lean Cash Cycle”, which it believes (based upon the EPC’s own cost estimates) could save up to €10Bn per year WITHOUT NEGATIVELY AFFECTING SEIGNORAGE REVENUES. Such a saving would actually be twice the saving anticipated by the Commission from the repositioning of both cash and cheques.

Question 2 **Do stakeholders have any comments on the gap analysis in Section 4?**

ESTA notes that the Gap Analysis states:

“At least we should aim to reposition cash and cheques in payments”

As described in the previous section, ESTA does not believe that cash and cheques are comparable instruments. In addition as will be developed in subsequent responses and the attached documentation, ESTA is concerned that cash substitution may actually disadvantage end-users and “society as a whole”.

ESTA would also caution that artificial attempts to shape consumer behaviour may have limited success, and could even be counter-productive. Cash is the most popular payment medium with consumers generally, and those on low incomes, not least because it has several unique features such as:

- ◆ Certainty of acceptance
- ◆ Immediate settlement
- ◆ No infrastructure requirement
- ◆ Ease of use
- ◆ Ease of monitoring
- ◆ Anonymity
- ◆ State-underpinning

Norway has been cited by some members of the EPC as an example of where interventionist actions have achieved substantial reductions in cash usage. In fact this is not the case: cash in circulation levels have not fallen substantially in Norway. However, there has been a significant shift in where consumers source their cash: retailer supplied cash-back transactions now exceed the volume of ATM transactions. ESTA believes that if such a shift were replicated within the Euro zone, this level of non-fitness sorted Euro recycling would be a serious concern for the ECB.

Norway has been highly successful in reducing the use of cheques, paper-based Giro's and over-the branch counter payment transactions and has achieved major cost savings.

Questions 3-8 *How can governance be improved?*

ESTA believes in open and competitive markets where regulators create a product-neutral even-handed environment and industry self-regulation is prevalent.

However, for self regulation to be effective it is essential that all stakeholders are fully aware of all the pertinent facts and actively involved in the decision making process. To date ESTA does not believe this has occurred within the SEPA process.

ESTA would wholeheartedly concur with the Commission that end-user consultation let alone involvement has been inadequate to date. Such involvement is essential if users are to choose to adopt new products providing new benefits desired by them rather than feeling alternative and possibly inferior products have been imposed, while their preferred products have simply been withdrawn. An alternative scenario is that if (from an end-user's perspective) poorly designed new products are launched in competition with successful existing products, end-users will simply choose the current product. ESTA believes that however greater end-user involvement is achieved in the future, it is essential that this is underpinned by in-depth survey-based consumer research to truly understand end-user opinions and preferences in all markets and segments.

The EPC is a grouping of banks and its membership is closed to non-banking parties. It cannot be right that one commercial interest group, no matter what their position within the payments system can control the destiny of such an important and wide-ranging project as SEPA.

ESTA itself has been frustrated by its own lack of involvement in this area: despite approaching both the EPC and the Commission on these matters ESTA is not represented at either the PSMG or EPC working groups. To date ESTA believes that while it has stimulated both interest and debate upon some of these matters it is still not considered a stakeholder within this process.

ESTA believes that there should be a SEPA Steering Committee drawn from all stakeholders within the payments process, chaired by an impartial public body such as the ECB, given that the ECB has explicit Treaty obligations with regard to payments.

Questions 24 *How can effective competition be ensured in all aspects of processing payments?*

ESTA believes it is clear that there is an underlying aspiration for cash to be "repositioned" relative to card-based payments within SEPA. In practice such a move would further reduce competition within the card-payments marketplace as cash is currently an effective competitor to electronic cards. The Consultation document notes the sectoral enquiry that DG Competition is currently undertaking into the market for payment cards. Such an enquiry is not unique: as noted in VISA Europe's 2005 Review, enquiries into multi-lateral interchange fees by regulators are ongoing in Spain, Portugal and the UK.

Questions 29 How can adoption of SEPA products by end users be ensured?

ESTA supports the view of Commissioner McCreevy that the Commission should be neutral upon the choice of SEPA payment methods selected by end-users.

SEPA payment schemes will be successful if they are products that European consumers want, providing new or enhanced benefits within a pan-European framework. ESTA believes end-users will be highly resistant to products or arrangements which are perceived to be engineered for the benefit of “big banks” rather than their customers.

Questions 36 How do other stakeholders perceive the adjustment cost of the transition to SEPA?

As stated earlier, ESTA notes that currently there is an underlying aspiration for cash to be “repositioned” relative to card-based payments within SEPA. ESTA calculates that over 100,000 people are employed in the production, handling, distribution and counting of cash. There is thus a very large social cost and impact to be considered if a major shift from cash to cards was to be engineered, which to date ESTA does not believe has been considered in the relevant impact assessments.

Questions 55 How can efficient payment instruments be promoted and cash and cheques be repositioned? How can the price signalling mechanism be improved to promote the use of the most efficient instruments?

ESTA does not believe that cash and cheques are comparable instruments (see response to question 1), nor that cash is inherently inefficient for the payment segments it serves. This can be illustrated by one of the most recent and substantial studies in this area undertaken by the National Bank of Belgium in 2004. The NBB simulated the effect of substituting 250 million cash transactions averaging €5 with payments of these sums by e_purse, and a further 500 million cash transactions averaging €20 being replaced with payments by debit card. The (variable cost only) saving to banks and retailers was only 0.02% of GDP despite this 5-6 fold increase in e-purse usage and a doubling of debit card usage. This prompted the Governor of the NBB to comment:

“Such a saving is rather low, even if a comparison is made at overall cost level (0.74% of GDP). Only a shift to a “cashless society” could generate substantial savings. This, however, is a purely hypothetical scenario, given the fact that it is cash that the public most wishes to use. Furthermore, it must be remembered that, in the context of such a radical scenario, the fixed costs of electronic payment methods would greatly increase: considerable investment in infrastructure, particularly in increasing the number of terminals, would be entailed, which might nevertheless generate in their turn positive scale effects.

Whatever the case may be, as its market share shows, cash continues to be the public’s firm favourite”

ESTA would contend that this does not constitute an endorsement of pan-European intervention in the payments market to discourage cash usage.

Questions 55 & 60 – Pricing Signals & Charges

ESTA views these questions as essentially the same. Furthermore ESTA believes that the underlying premise – that cash in many countries is “free” is profoundly mistaken.

Simply because cash may be “free at the point of dispense” – the ATM, this does not mean that the public are not paying for cash. Their preference for cash cost them around €16Bn in the EU15 in 2003 for example. This is because Seignorage is effectively a tax on the public for holding cash: the public forgo an opportunity to earn interest by holding state-issued IOU's while the State invests the value it receives for issuing these IOU's. The return generated by the State from this investment is real revenue, that is spent on real things such as schools and hospitals, without the State needing to raise more direct (and probably less efficient and less popular) forms of taxation.

Cash is different to other forms of payment in one crucial respect: it is owned by the State and not the banks. When a bank launches a payment product it expects to generate a return. However, since cash is actually the State's payment product, it is the State that generates a return through the use of cash.

When this fundamental distinction is understood, the relative efficiency of cash in comparison to other forms of payment can be truly revealed (Net Societal Cost of Cash), and cash is a very competitive product. If the banking industry received the Seignorage revenue rather than the State then ESTA believes the current lobbying against cash would never have occurred, as cash would actually be a profitable product for Commercial Banks, and the banks would probably be encouraging an expansion of its use.

The banking industry may currently argue that it is not adequately recompensed by the State for its role as a “distributor” in the cash cycle. This situation has however prevailed since the State monopolised banknote issue. What is new is that commercial banks now have alternative payment instruments to compete with State issued cash: payment cards.

ESTA does not believe that the European public should be drawn into a competitive dispute between the commercial banks and the Member States. If charging for cash at the point of dispense is introduced under the guise of “*price signalling to promote efficiency*” then the public is effectively paying both the State & the Commercial Banks for access to cash. Not only is this unfair and likely to be highly unpopular with the public, but far from creating a level competitive playing field as is being portrayed, it will actually have distorted the market against cash: cash will be the only payment instrument bearing a direct tax burden (Seignorage) and providing a commercial revenue stream. ESTA would contend that such a distortion would probably be unacceptable to the Member States in the longer term, and so the logical result would be for the State to rebalance the competitive market (and recover lost revenue) via some form of tax (either direct or indirect) upon card payments.

ESTA does not believe that the payment market currently merits such radical interventions, particularly as end users tend to segment their use of payment systems broadly in-line with banking / retailer costs. Furthermore ESTA is convinced that the current costs of the cash cycle could be dramatically reduced by up to €10Bn a year (based upon the EPC's own cost estimates) by a concerted effort involving all stakeholders to fundamentally re-engineer the cash cycle. However, such an opportunity can only be exploited with the commitment and dedication of all stakeholders to designing an optimal solution.

These themes, the detail behind ESTA's thinking upon re-engineering the cash cycle and the supporting reference material are included in the attached document "*Cash Substitution: Issues and Implications*"

Questions 56, 57 & 59 – Legislation, Pricing and Consumer Reaction

ESTA has responded to these questions as a single group as they appear to have similar underlying issues.

In some countries there may, or may not, be legislation to exclude charging for cash from ATMs. However, legislation is not the whole story: the political and public mood that creates and shapes legislation is just as important. To provide a flavour of these issues ESTA has provided some quotes below from the UK Treasury Select Committee Report on Cash Machine Charges, and the subsequent Adjournment Debate in the House of Commons:

In the conclusions to their report the Select Committee stated:

"As part of an agenda tackling financial exclusion, it is very important that those on low incomes have access to free cash withdrawals. We note evidence that the cash machines most likely to be converted to charging are those away from existing bank branches in low footfall locations. If there were to be a substantial reduction in the availability of free cash machines then that could exacerbate existing financial exclusion and the Government needs to keep developments under review."

While in the follow-up debate John McFall MP, Chairman of the Committee noted:

"The Government's move to direct payments will result in increased cash machine usage amongst benefit recipients, and if they have problems getting free access to their money they will have less available for other essentials"

Ian Lewis, Economic Secretary to the Treasury concluded:

"It is absolutely clear that the Government and the Select Committee have a shared objective, which as far as I can see is to maximize access to free cash machines. That is particularly important for people in disadvantaged communities and vulnerable individuals"

ESTA does not believe that the Commission should take responsibility at a pan-European level for any initiative that would increase ATM charging particularly when there is so little support for it in Member States and it is likely to provoke opposition from consumer organisations (as per Q58 in the consultation document). In such an environment there must be a risk that the highly positive aspects of SEPA are jeopardised.

As noted earlier ESTA would contend that ATM cash is actually a low cost mechanism in comparison to other payment forms and it is primarily the manual branch based or paper based transactions that drive banks costs. These latter issues can be addressed without distracting from the core SEPA objectives.

Questions 58 – Best Practice

Norway & Finland are often quoted as examples of best practice in the area of payments, and indeed both countries have reduced the cost of payments to the banking sector. However it is important to note that this has not been achieved by a significant shift away from cash in circulation. In fact cash is more popular in Finland today than ever: Finns expressed a strong preference for cash (49%) when asked *“their preferred means of payment for an important purchase (over €100) in their own country”*, making cash the most preferred instrument. This was even greater than the overall EU15 average cash preference of 46%.

ESTA believes that the key to lowering the cost of cash is to automate and simplify the inflow (depositing) cash cycle to a similar degree to that achieved in the outflow (dispensing) cycle via ATMs. A fundamental re-engineering of this kind could yield up to €10Bn per annum (the cost difference between the two cycles as estimated by the EPC) To date no individual country has vigorously pursued such a strategy, but some banks are further down the automation process than others. ESTA believes that the foundations of such best practice could therefore be substantially expanded upon if there was a common purpose among all stakeholders.

Questions 62 – Customer Mobility

ESTA would contend that the launch of the Euro currency created a de facto Single Payments Area for end users paying with banknotes and coins throughout the Euro zone. ESTA would also note that there are no “lock-in” mechanisms to users with cash and no technological infrastructure requirements. Cash therefore fulfils the requirements of a SEPA payment product today. Unfortunately its best of breed status has been overlooked because most studies have focused solely upon the costs to the banking sector. When the fundamental difference between State-issued money (cash) and privately-issued money (payment cards) is understood and examined in more detail, the efficiency of cash becomes apparent.

ESTA is confident that the Commission will take a macroscopic view of these issues for the benefit of European society as a whole, rather than the narrow view currently being promoted by the EPC.