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The move to instant payments – is it really such 'a seismic switch?'

Tinatin Akhvlediani and Fredrik Andersson

Explainer

The European Commission published a proposal on instant credit transfers in euro in October 2022. The proposal will in practice mean that money being transferred from one account to another should be received by the recipient within a matter of seconds at any time of the day, every day of the year. The Commission argues that this will bring numerous benefits to consumers and businesses, and will promote innovation in financial services.

But it will also come with several challenges for Payment Service Providers (PSPs), particularly in the short run. In the long run however, the benefits linked to innovation, user experience and cost reduction should outweigh the costs of implementing IPs.

Introduction

In October 2022, the European Commission published a proposal on instant credit transfers in euro. As presented by Commissioner Mairead McGuinness, the switch from next-day payments to instant payments (IPs) is 'seismic, comparable to the move from mail to e-mail'.

Such a 'seismic' switch will in practice mean that money being transferred from one account to another would arrive within a matter of seconds at any time of the day, every day of the year. This is not always the case in the EU. In fact, a credit transfer between banks at national and EU level in the Single Euro Payments Area (SEPA) may currently take anything up to three days to be fully executed.

Nevertheless, the possibility to facilitate IPs in the EU has been theoretically available through the Instant Credit Transfer scheme (SCT Inst) since 2017. But even five years down the line, the uptake of IPs in SEPA countries has not managed to exceed 14 %. The Commission's proposal is supposed to be a remedy to this limited uptake.

European Credit Research Institute (ECRI) at the Centre for European Policy Studies
1 Place du Congrès, B -1000 Brussels, Belgium
Tel: +32-(0)2-229.39.11; info@ecri.eu, www.ecri.eu

Digging deeper into the Commission's 'seismic switch' proposal

The proposal sets four requirements for IPs. Firstly, instant euro payments must be made available by all Payment Service Providers (PSPs) offering credit transfers. Secondly, providers must also ensure that these are available to users at an affordable price, implying that the price charged on IPs cannot be more than the price charged on non-instant credit transfers. Thirdly, IPs should increase consumers' trust in the process by obliging PSPs to verify the match between the bank account number (IBAN) and the name of the beneficiary. They should also warn the payer of a possible mistake or fraudulent before the payment is made. Fourthly, the proposed regulation is supposed to avoid friction in processing IPs by effectively screening for any possible breach of EU sanctions. In practice this will require PSPs to verify their clients against the EU's sanctions list every single day.

PSPs have been given a period of six months to set up a system capable of receiving instant credit transfers. To make transfers, PSPs have been given an additional six months to ensure that payments to any bank that is part of SEPA can be made. For Member States outside of the euro area, PSPs would be given 30 months to receive instant payments and 36 months to send them.

The proposal builds on the EU's payment policies, particularly the Payment Services Directive (PSD2) and the Regulation on cross-border payments. PSD2 sets the rules for PSPs and credit transfers in the EU, while the Regulation on cross-border payments ensures that cross-border euro transfers are offered at the same rate as domestic payments in national currency.

Credit transfers are already required to follow the obligations set out under these two pieces of legislation and will continue to be aligned even after the IPs proposal has come into force. Changes to the rules set up under PSD2 are currently being formulated following a detailed review and these are due to be announced in summer 2023. The proposal is also consistent with the EU's digital finance strategy.

The proposal currently does not cover payment institutions (PIs) and e-money institutions (EMIs), as they do not have direct access to settlement systems. PIs offer payment initiation and account information services regulated under PSD2 and EMIs (organisations that issue electronic money), are regulated under the Electronic Money Directive 2. They have limited access to settlement services and only have indirect access to settlement participation, meaning that they rely on banks to access the system. The Commission therefore considered it disproportionate to demand an instant payments offer from these actors, but they are permitted to offer IPs on a voluntary basis.

Are we ready to make the switch?

In the eurozone, PSPs have already been synchronised by following the 'payment scheme' that guaranteed the same terminology during the clearing and settlement mechanism between PSPs. This mechanism remains constantly operational, 365 days a year.

To remove all infrastructural cross-border payment issues, the ECB made it mandatory in 2020 for all PSPs to adhere to SCT Inst and to be connected to the TARGET Instant Payment Settlement (TIPS) system. In practice, this required all national Automated Clearing Houses (ACH) to transfer all technical accounts to TIPS before 25 February 2022.

So far, several instant payment schemes have been developed in multiple EU countries. They offer instant payments in domestic currency but only for their domestic market, while instant cross-border transfers remain very limited across the SEPA area.

The shining stars

Estonia is the eurozone's clear leader with IPs representing two-thirds of all credit transfers in 2020. However, IPs are not free but merely cost the same as a regular transfer.

Another eurozone frontrunner is the Netherlands where 95 % of all payment accounts have access to instant credit transfers. In 2015, an industry-led initiative to build IP infrastructure in the Netherlands was launched by the four largest banks in the Dutch market. Essential stakeholders such as the Dutch Payments Association and the Dutch Central Bank were involved in this process from the very beginning. This has resulted in a highly-developed market where mobile and internet banking transactions are now both free and instant.

Outside the euro area, Denmark, Hungary and Sweden all had an uptake of instant payments exceeding 30 % of all credit transfers in 2020.

In Hungary, the main driver of the high uptake has been Hungarian legislation which requires all payments below HUF 10 million (just under EUR 27 000 at the time of writing) to be instant. This is all done mostly through the Hungarian Central Bank's 'Azonnali Fizetési Rendszer' (AFR) instant payment system, in cooperation with the Hungarian clearing house GIRO Zrt and numerous PSPs active in the market.

In the Nordic countries, the high uptake of IPs was mainly driven by banks setting up dedicated payment services to allow IPs for peer-to-peer (P2P) transfers. The regulatory framework has followed market developments to ensure compliance with SEPA and SCT Inst.

In Sweden, payments are not offered through traditional credit transfers between banks. Instead, IPs are made through the dedicated 'Betalningar i realtid' instant payment system, which is operated by Swish, a platform that launched in 2012 as a collaborative effort between six of Sweden's largest banks. Starting from 2023 Swish is now required to pass all transfers through the RIX-INST settlement service, a new system set-up by the Swedish Central Bank (Riksbank) to guarantee IPs' safety and security. In practice this means that all IPs are settled through the Riksbank.

Swedish supervisors have agreed with the European Payment Council (EPC) to ensure that all transfers made in euro are as closely aligned with SCT Inst rules. Additionally, all IPs executed in Sweden are settled according to ECB TIPS, thus easily facilitating any future changes.

Just like Sweden, Denmark offers a dedicated scheme for IPs – MobilePay – covering 85 % of the Danish population. In 2020, the uptake in Denmark reached 37 %. Denmark has a rulebook based on a licence agreement with the EPC and is compliant with most of the SCT Inst. Full compliance with TIPS is expected by 2025.

The slackers and the new kids on the block

On the opposite side of the spectrum, we have Romania, Poland and the Czech Republic, where IPs only amount to around 10 % of all credit transfers – at best. The reason behind such a low uptake is mainly due to the fact that IPs are offered as 'premium' services.

In Romania, PSPs are already compliant with SCT Inst. In 2020 there were five banks offering IPs as a premium service but they only amounted to a measly 1.25 % of all credit transfers.

Like in Romania, IPs are offered by multiple market actors as a premium service in Poland. Examples of market actors include Express Elixir and BlueCash, yet IPs only amounted to around 2 % of all credit transfers in 2020.

Using IPs is also a premium service in the Czech Republic, where it is mainly used for fund transfers. Uptake was about 10 % of all credit transfers in 2020.

Finally, there are two newcomers to the eurozone – Croatia, which officially joined the eurozone on 1 January 2023, and Bulgaria which will join in 2025. Accession will require each country to implement the proposed regulation on IPs in full. They will find themselves aligned with SEPA and SCT Inst by default, especially as both countries already have national IP schemes in place based on SCT Inst.

Meanwhile, credit transfers in Bulgaria are almost exclusively done in Bulgarian lev but with the IP system being based on SCT Inst, transferring from lev to euro should not require any substantial changes.

Prior to joining the euro area, the situation was very similar in Croatia, where credit transfers were almost exclusively done in Croatian kuna but with IPs built on SCT Inst, the switch to euro credit transfers has been easy. All that remains for Croatia is the integration of cross-border transfers, expected to be done by Q2 2023. But the rollout of IPs could be challenging as the current uptake of instant payments in Croatia is marginal.

The effects of flipping the switch – the possible advantages…

Flipping the switch on IPs is supposed to lead to significant positive developments. But it will also mean facing and overcoming some major challenges as well.

The IP proposal is supposed to accelerate the speed of payments which will free up billions of euro currently sloshing around in the banking system. It will drive innovation and reduce risks and costs associated with the other means of payments.

Unlocking billions from the 'float'

Real-life payments would unlock billions of euro currently locked in transit within the financial system, the so-called 'payment float'. According to the European Commission, almost EUR 200 billion is locked away on any given day in the financial system. Unlocking the money from the float will definitely benefit consumers, businesses and public administration, enabling them to make cost savings on their working capital.

PSPs and banks can use the float to their advantage, by earning interest on the money available in the float. However, the income generated for PSPs by the float in the system is estimated at only 0.3 % of the banking industry's total annual net operating income[1]. Losing this source of income would therefore only have a limited impact on the banking system and would be compensated by the benefits reaped by users.

[1] This reference number comes from a 2022 study, based on data collected before the rise in inflation and interest rates, and thus is likely to have changed considering the much higher interest rates we are experiencing today.

Driving innovation

The proposal has the potential to drive innovation and competition. Today, payment solutions are limited at the point of interaction (PoI) between merchant and customer, with card and cash being the main means to pay.

IP payments have the potential to enable merchants to receive payments for lower prices than is currently the case and could even lead to transactions becoming free for the merchant. This will create new competition for traditional payment schemes, pushing them to innovate and offer new payment solutions to merchants.

The new rules also incentivise Payment Initiation Service Providers (PISPs) to develop new innovative payment mechanisms that could potentially provide cross-border payment solutions, supporting the move away from the current domestic services. Combining the Instant Payments Directive with open banking could trigger innovation and the development of new means of payments for consumers. Open banking could also be used to facilitate quick and efficient data verification, required to make a secure credit transfer in under 10 seconds.

Decreasing risks and costs for other means of payments

Switching to instant payments will importantly reduce the risks and costs for merchants associated with other means of payments. Substituting the handling of large volumes of cash by instant payments will significantly reduce the risk of theft/robbery. Limiting the use of cheques in favour of instant payments does away with their high handling costs compared to other means of payments.

Additionally, the new rules will facilitate public authorities' supervision and tax collection and could even contribute to the fight against tax evasion.

… and the challenges to overcome

However, flicking the switch will also unleash some major challenges, all of which will require PSPs to reconsider their operational capacity, infrastructure, profitability and business model to comply with the forthcoming regulation.

Operational capacity

For PSPs to be able to send and receive euro IPs, five key requirements are necessary.

Firstly, it requires the PSP to be part of SCT Inst. To adhere to SCT Inst, a PSP must comply with specific requirements. Secondly, the PSP must integrate an instant payments module into their IT system and adjust online and mobile banking interfaces (including APIs). This is to make sure they have the capacity to receive IPs in euro, enabling users to send instant payments, and an IBAN verification that gives immediate feedback on whether a payment has been successful. Thirdly, the PSP must update all of its documentation. Fourthly, it must connect to a clearing and settlement mechanism that fulfils the instant settlement obligations. Finally, all PSPs must ensure the 24/7 availability of their IT support (e.g. chatbots).

Having these key requirements in mind, it will indeed be challenging for PSPs to set up the required operational capacity in time to smoothly execute IPs under the new regime.

Infrastructure for moving from bulk to instant payments

Current infrastructure does not have the capacity to handle instant bulk payments and changes to the system would be required for banks to process them on an instantaneous basis. Bulk payments are

commonly used by corporates, which only operate during traditional working hours, limiting the need for keeping the payments infrastructure active at all times.

Safety and security

IPs should be possible without compromising the safety and protection of the transfer, from the moment it leaves the sender's account up until it reaches the recipient. When a credit transfer is made instantly, the timeframe to recover funds due to error or fraud becomes much more limited, narrowing the possibility to correct mistakes and reclaim funds. This is particularly important as once enforced, the IPs regulation will require banks to verify an IBAN in a matter of seconds. The other facet of this limitation is when a transaction is fraudulently done, supervisors have very few options to block or identify fraudulent activities.

To ensure security and compliance with sanction lists, banks will need to put in place fast and reliable sanction screening mechanisms, 'know-your-customer' processes and monitoring tools. This will require PSPs to invest time as well as financial resources to guarantee safe and secure IPs. Complicating the verification process is the lack of a pan-European IBAN name-check solution.

Costs

According to the proposal, PSPs are obliged to offer IPs at the same price as traditional credit transfers. However, being compliant burdens the PSP with additional operational capacity and infrastructure development costs. This requires PSPs to free up time and resources and potentially even to reconsider business models so they can afford to be compliant with the proposal.

Competition

Once in force, the proposed regulation would heap pressure on PSPs if they struggle to implement or are unable to bear the costs of offering IPs at the same price as regular transfers. Consequently, enforcing the regulation will have a direct impact on market players and competition in the credit transfer market.

It is more likely that the large and most efficient PSPs will remain competitive while other market players might be forced out unless they find new and disruptive innovation tools that can cut costs.

Timeline

The proposed timeline might be challenging. Across the EU, one-third of PSPs are still not ready for the rollout of instant payments. Implementing the proposed regulation will be costly and will require PSPs to reconsider their operational and infrastructural capacity. In short, they may need more time than the proposal allows for.

Non-euro countries

By extending the timeline for adopting IPs in non-euro countries, the proposal recognises that non-euro countries lag behind in terms of euro transfers. However, having more time may not necessarily translate into successfully finalising and implementing all the necessary infrastructure for receiving and sending IPs. This may require more proactive stimulus from the relevant regulatory bodies at both national and EU level.

The digital euro

The possible interaction between IPs and the digital euro has created additional uncertainties. The two payment methods would both enable 'euro' credit transfers to be instant. With very similar benefits for the end user, they run the risk of competing with rather than complementing each other. This may lead to questions about the continued relevance of IPs, if it appears that a digital euro could quickly supersede them.

However, the digital euro is still just a topic of discussion, a mere possibility without a clear and concrete plan on the timeline, design or scope of its practical use. This indicates that IPs should still yield clear benefits before the introduction of a digital euro, likely to be several years – if not longer – down the road.

Conclusions

As illustrated by the very limited uptake of IPs in the EU, neither regulatory stimulus through the creation of a special scheme for IPs (SEPA and SCT Inst) nor market forces have provided a sufficient incentive for PSPs to adopt or develop new technological solutions to the extent hoped for by regulators.

At best, instant payment schemes have been developed in EU countries solely for the domestic market and cross-border IPs in euro remain very limited. So here comes a proposal for a new regulation that will oblige all PSPs in the SEPA area to provide instantaneous, secure and affordable transfers for their users. With this, it aims to bring about a 'seismic switch' from next day to instant payments.

While the switch may come across as a simple step for catching up with the technological solutions available, taking this step forward will not be as simple in practice. The switch will require PSPs to adjust their operational capacity, infrastructure and even reconsider their business models and profitability to ensure their compliance.

On the other hand, the proposal could result in some very real benefits by accelerating payments, unblocking the billions of euro floating in the financial system, driving innovation, making credit transfers more secure and reducing the risks and costs associated with traditional means of payments (just to quote a few).

While individuals, businesses and particularly SMEs, NGOs and public administrations will be the main beneficiaries of the new rules, compliance costs will no doubt be a burden for certain PSPs. But, as evidenced by the frontrunner EU countries, the sooner banks start creating infrastructures and schemes for IPs, the smoother and faster the technological solutions can be adopted to facilitate and even improve their operations and services provided.

And so the switch is seismic and the challenges associated with the switch will also be seismic, primarily for PSPs. But so long as no one falls asleep at the switch, the potential benefits linked to innovation, the overall user experience and long-term cost reductions could far outweigh any initial drawbacks.

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