

Clearing the SEPA way

It's time for action!



*SEPA End date
regulation demands
immediate action*

Highlights

- European Parliament sets 1 February 2014 as SEPA migration end date
- Migration challenge must become a priority for banks and corporates alike
- Build a migration plan using the "SEPA checklist"
- Determine the business value of achieving compliance
- Adopt a "no regrets" messaging solution

Executive summary

We recently published a paper entitled *Will the SEPA End Date really change the game?*^[1] in which we debated the forthcoming SEPA end date regulation and the various reactions of different stakeholders. This first paper concluded that with full SEPA migration only a couple of years away, "wait and see" cannot be an answer. There is no other choice for banks, businesses, public administrations and clearing systems than to build a plan to achieve migration and stick to it - because there is no doubt that the transition will take place. Institutions therefore need to have a clear view of where they are starting from, where they are going, and what they need to get them there.

In a recent report, Celent^[2] confirmed our conclusion, stressing that "for banks, doing nothing is simply unlikely to be an answer". While this is obvious, banks do need to know WHAT to do to address their compliance challenges. Capco^[3] said roughly two-thirds of financial institutions have to date no clear strategy or plan to address SEPA regulation. The available time is shrinking - and budgets are too.

While most large institutions are ready, many medium to small-sized ones are still watching and waiting for the dust to settle and the shape of the future landscape to be clarified. The latter institutions urgently need to formulate a plan and ask themselves a number of questions. Is this plan sufficient? What's the reality ahead? What and where are my business flows? Am I equipped today and tomorrow in this evolving SEPA landscape? Is my clearing

business challenged by others and can I defend myself against this competition? In this paper, we will look into what can be done to ensure that the decision making process takes into account all necessary aspects of an institution's *status quo*.

Metrics and flow analyses should help shape the "as is" situation for institutions as regards their exposure to SEPA compliance. This "as is" situation can be summarised into a SEPA checklist and a SEPA heat map per institution. Answers to the above questions are at the core of the decision making process and will have a large impact on the strategy and the sequence of actions to be taken. Institutions will need to decide what the future will look like for the activities impacted by SEPA (and also for other similar ones as the case may be). The defined "to be" situation will be a driver for the next steps as regards compliance to SEPA. While choices have already been made by some, many still have to define their party line and shop around for services or opt to develop their own SEPA package inhouse. A roadmap needs to be drafted, reviewed, approved and adhered to.

Implementation can also involve outsourcing and while SEPA offerings are not widely publicised in the market today, there is no doubt that the publication of a definitive end-date will accelerate progress and raise awareness with institutions that it is time to move ahead. In preparation for a forced migration, it is even more important to have assessed the way forward for one's own institution and move according to a well thought-through roadmap.

At a time when minds are focused on discussions regarding the details of the regulation, we felt it would be interesting to take stock of the latest developments and assess how an industry-owned cooperative such as SWIFT may be able to help clarify the way forward and support market players as they grapple with how to meet their compliance obligations. In this paper we set out the support we can provide to clear the SEPA way for tomorrow.

Introduction

In our previous paper we stated that a “wait and see” approach would not be the wisest route to follow for SEPA migration. Despite the fact that the economic climate and the current crisis are diverting the attention of regulators towards considerations of the future of the euro and the eurozone, the so-called “end date” regulation approved by the EU Parliament on 14 February 2012 and further ratified by the Council on 28 February 2012.

The three-way discussions between the EU Parliament, the EU Council and the EU Commission finally settled on and confirmed the following main points:

- A common and single end date of end January 2014 for the migration of euro retail credit transfers and euro direct debits to SEPA instruments.
- An exclusion of the High Value Payment Systems from its scope.
- Mandatory use of ISO 20022 XML as the standard for euro retail CT and DD messages for the interbank space AND for customers sending or receiving bulk files.
- A ban on per transaction Multilateral Interchange Fees (MIFs) for DDs as from 1 November 2012 for cross-border and 1 November 2017 for domestic direct debits, not prohibiting fees on R-transactions.

It could be a cause for regret that some obligations were not retained in the end, such as the obligation for end users when initiating transactions to provide both BIC and IBAN. This could result in an awkward situation since after years of insisting that both BIC and IBAN are necessary to correctly instruct and route a payment, end users and more specifically corporate customers and public administrations that have already invested heavily in updating their accounts payables databases end up being suddenly released from an obligation that was imposed on them. This mixed message may well, once again, slow down buy-in and migration rates, since payment instrument requirements will be in the hands of the regulators and hence potentially subject to further changes.

One certainty is that 24 months to move to full SCT and SDD usage represents a serious challenge, regardless of the fact that some institutions have already prepared their migration plans. Even fully operational institutions may need to tidy up their processes and applications (and scale them up) to meet their obligations.

On the whole, however, the above requirements will not cause great surprise in the industry because most interested parties will not discover any surprises in the regulation itself. So how can we explain the overriding feeling that there is little or no sense of urgency to move ahead among stakeholders? This regulation was precisely put together to:

- Address the lack of momentum in the migration and accelerate the natural move towards the new payment instruments, standards, networks and business models and
- Form the basis for enabling innovation in payment methods/channels towards end users.

So why the stalling and the doubt?

It is interesting to note how difficult it still is to build up a uniform offering that is truly SEPA-wide, despite the fact that there are now harmonised payment instruments in place. Cross-border direct debits, for example, are a very good example of the complexity involved in performing SEPA-wide collections. The first few months of operation are showing reject and return rates that are far above

those commonly admitted at a domestic level, not to mention other problems in the workflows. This exemplifies the fact that SEPA actually requires an in-depth re-engineering of end-to-end processes in banks and communities alike.

Hoping that these issues will merely be teething problems is misguided. The issue is that a real take-off of the cross-border direct debit can only happen when sufficient guarantees are present for creditors too (such as a complete understanding of what it entails to direct debit). As things stand today, the situation is far from clear. Some communities are preventing by default direct debits to customer accounts unless explicitly authorised by debtors. The scenario in which debtors get their banks en masse to unlock this situation remains to be seen. In these conditions, the value proposition for potential creditors willing to centralise their collection processes is weak, to say the least, and really no better than it ever was in the past. So creditor banks will have to invest heavily in education in order to increase uptake of this new, cross-border direct debit facility product.

While a few players (especially the bigger ones) have heavily invested in SEPA services, the vast majority, according to Capco, are still standing on the shore, asking themselves which type of boat they need to build or buy to embark on the SEPA journey. Celent says: “There will be winners and losers in the journey ahead, but the control over which group they may fall into is not necessarily in the hands of the players... In delivering SEPA, many banks are potentially signing their own death warrant - and paying for the privilege”.

There is no guarantee either that those who started to prepare early will be the winners, as many have since strayed from the project path. Some of the “wait and see” latecomers may well overtake them once full information on the SEPA journey is clearly analysed and understood. Proof of this is that even scheme operators will soon be progressively phasing out their SEPA services (see Vocalink’s^[4] announcement of 22 August 2011), although one could argue that an operator based outside of the eurozone will have by definition more difficulty in attracting volumes for such services, especially

since the migration to new instruments failed to take off for good over the past 3.5 years.

The winners may well be those that are capable of leveraging the investments they've made up until now and making an attractive product out of their accumulated knowledge and know-how. This is where the money is for bigger players and they may not necessarily call for long delays before the end of migration in the hope of attracting as many customers as they can. The setting of an end date will undoubtedly accelerate offerings in the market to lower tier institutions, which are likely to be forced to make choices in a very short period of time as implementation and readiness testing windows will shorten even more.

With the regulation giving final clarity on the way forward, what is important now for the banks is to work out how to achieve compliance by the deadline(s). Some have had their strategy set and ready to go for a while. For the others, the "wait and see" approach will no longer work. It's time for action.

Assessing the impact and navigating to compliance

As you make your SEPA plan, you need to take a series of preparatory steps to ensure that everything goes as smoothly as possible.

These include:

Plan ahead from the start

When asked, everybody would declare they have a complete overview of what they clear, in which channels, and what the stakes are in each and every one of them. Our experience shows though that this picture, whilst generally accurate, is often lacking completeness, not homogeneous enough or even outdated. Furthermore, collecting and cross-checking this data is often very cumbersome and resource and time consuming.

This problem can be even more acute in bigger institutions with remote operation centres or complex hierarchies, often with a silo working structure. In its report Celent stresses:

Furthermore, these banks have often grown to the size they are through mergers and acquisitions and often have the most complicated of payment setups, with 40 plus systems not uncommon. The path to SEPA requires significant work even just to reach a state that can be migrated from.

Getting a clear picture is nonetheless critical in order to correctly plan the steps ahead.

Take away #1: get as clear a situation as possible from the start.

Supported by the new tools we have available, we can assist you in putting together a complete view of your starting point, channel by channel and transaction type per transaction type. This is helpful as sometimes the real picture is very different to what the many parties within an institution believe and the help of an independent third-party can be essential in gaining acceptance of and building consensus on the status quo.

Purpose of the journey

The purpose of the journey to SEPA compliance is to make sure that all your business lines are aligned and payment instruments migrated in time. You need to make sure that all aspects of SEPA compliance are taken care of, and a "SEPA checklist" needs to be made.

This SEPA checklist focuses on the pain points around compliance. It is important to have a holistic view of both the instruments bound to migrate and the most appropriate channels to be used. The EC regulation is far-reaching and

extends to corporate acquisition channels and the bilateral relationships a bank may have with its peers (even if not considered as a clearing system per definition).

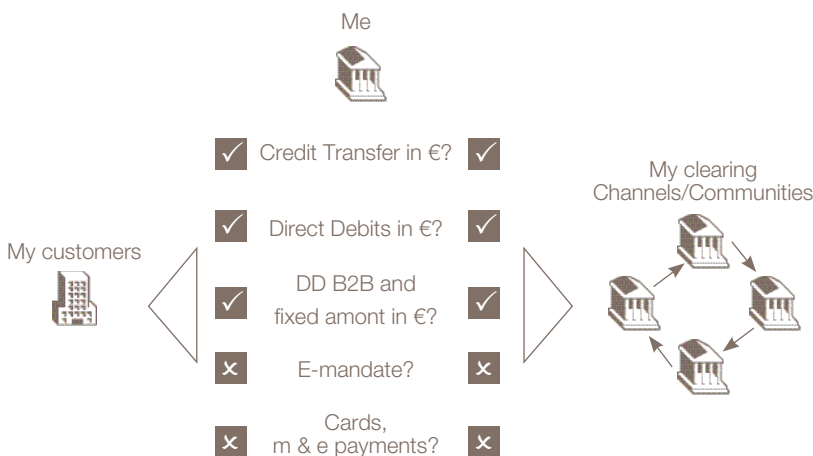
Take away #2: make sure the focus is where it should be, and make a complete review of your workflows and obligations.

This SEPA checklist needs to encompass the volumes and the strategic importance of the relative payment instruments dealt with. This will have an impact on the next steps of the journey.

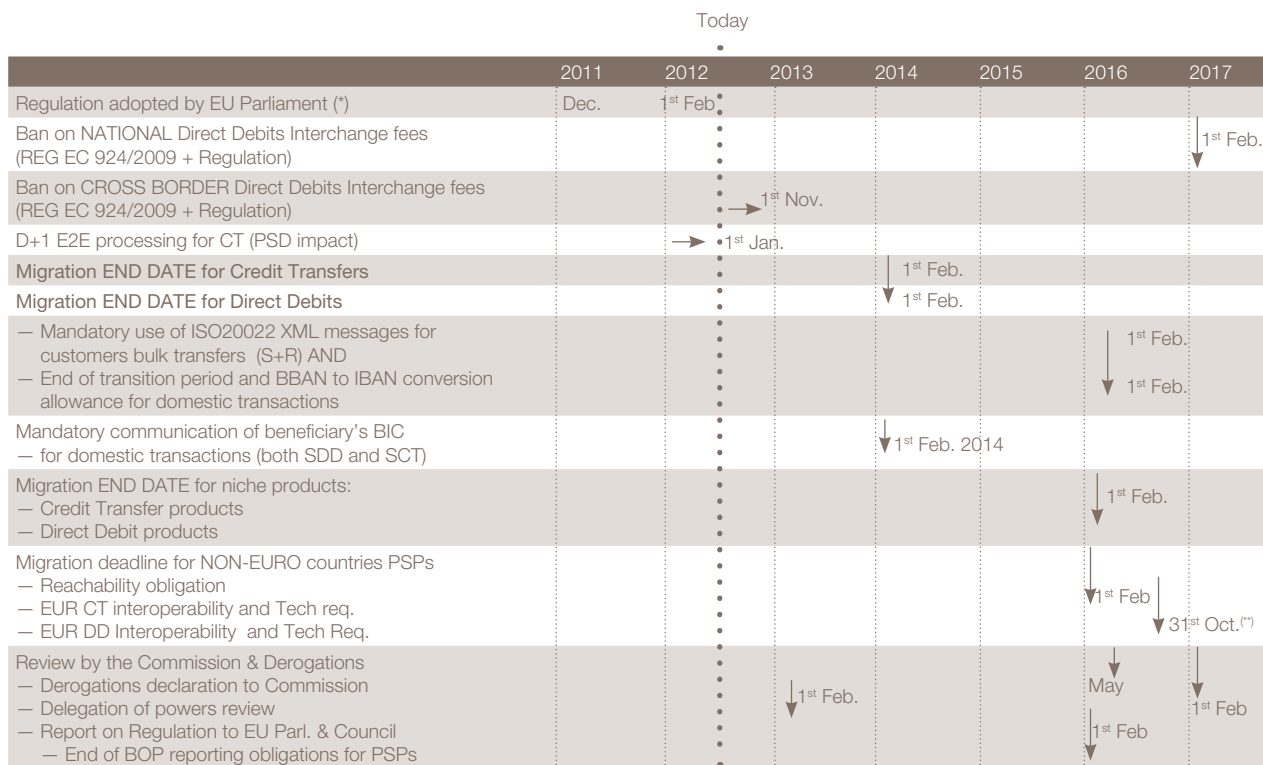
Check the weather forecast

The SEPA weather forecast is difficult to predict because some points will be left to the discretion of national communities (as they will undoubtedly revise their published national Migration Plans) and derogations may well surface in some countries, rendering a uniform implementation difficult. A good example of this so far is the contrasting situation in the migration rates between the euro countries. While on average it is ramping up, there are still large countries that have made very little progress. Even with the end date set, it is likely that the migration will not be homogeneous across the eurozone.

In the introduction to this paper and in the previous one, we explored the overall landscape for SEPA migration. As already mentioned, the end date itself is just a milestone. The diagram below is a recast of the table we published in our previous paper.



▲ My SEPA checklist



Ⓜ Roadmap

(**) or 1 year after EUR is being introduced in this member state

Take away #3: make sure you know the potential issues, the order in which you'll have to deal with them and the probability that they will materialise for you

Investing time and resources in keeping abreast of the evolution of the legislative environment both at European and local levels is difficult and often still results in an incomplete picture. It is therefore important to get close to a reliable partner and leverage its intimacy with the legislation and information feeds.

Trends and competition moves at a country level, or more broadly in the wider region, need to be factored in. Certain aspects of the situation can change quite drastically without prior notice. For example, the validity of mandates for SDD in Germany should only be inked in law in July 2012, although the obvious desire is to not debate this any further. Obviously, even if the confidence in your situation assessment is good, you may still want to cross-check what the competition and your peers are doing and overall trends in the geographies/currency/product types you're dealing with.

Take away #4: make sure you cross-match your assessment of the situation with an external partner, gathering knowledge of market data (and backing analysis with fact, rather than rumours or hearsay).

Business Intelligence provides a unique opportunity to perform deep analysis and either confirm observed trends or disprove preconceived ideas. It needs to be used as a benchmark against which to measure your institution's own analysis before taking any drastic business decisions.

Determine your itinerary

It is important to work out what is feasible and what is not, and how issues can be addressed.

Time will be pressing and some decisions must be taken very quickly. It is worth factoring the following considerations into the decision process:

- Clearing strategy: does it match the evolving SEPA environment and can you devote sufficient resources to achieve compliance by the deadline? If not, are there activities you need to stop doing or do differently?
- Ambition and appetite: do you see

clearing as a commodity or an opportunity?

- Competitive positioning: are you realistic in your clearing strategy given the environment you are operating in, today and tomorrow?
- Critical size: is your clearing business big enough to contain competitive pressure and allow for further expansion without heavy reinvestment?
- Steps and milestones on the way: navigating the compliance path might prove quite complex. What external expertise do you need to fill knowledge- and skill gaps during the transition?

To help, we have drafted a "SEPA heat map" which helps you to visualise by payment instrument and per business line the mandatory steps for your institution.

Celent correctly states: "SEPA is not just new payment types, it's about rebuilding the payments business from the ground up to create competition at all levels of the business... SEPA will lead to a fundamental rebuild of the payments business. SEPA creates a new environment for payments, from

| By when, what | 2014 | 2016 |
|--|--|---|
| Customer bulk flows (obligations for PSPs to accept from customers) + conversion services for free | Accept XML remittances and IBANs to BICs conversion for bulk CT and SDD (1st Feb), including BBANs to IBANs conversion | |
| Retail EUR clearing flows on domestic or X-border ACHs to EUR countries | – ISO 20022, BIC and IBAN for Credit Transfers (1st Feb) – ISO 20022, BIC and IBAN for Direct Debits (1st Feb) | |
| Ban on CROSS BORDER Direct Debits Interchange fees (REG EC 924/2009 + Regulation) | | |
| Retail EUR clearing flows on domestic or X-border ACHs to / from non-EUR countries | | – Credit Transfers (31 st Oct) – Direct Debits (31 st Oct) |
| Migrate “niche” products if any | | – Credit Transfers (1st Feb) – Direct Debits (1st Feb) |
| Reconsider business model for SDD without MIFs (in countries where MIF applies) | | –End 2014 for ban in 2017? |

④ My SEPA «Heat map» for EUR traffic

standards to networks to business models.” We’re fully in line with these comments. Anyone considering SEPA as “just” a format issue is making a mistake. They risk making wrong decisions and may well build up loss makers for the future.

Go for the “no regret” messaging solution. Make sure you’re betting on the right messaging solution for SEPA, especially if the domestic clearing business may one day be outsourced to a foreign operator. Our FileAct service is the messaging access means already offered by 21 clearing services across Europe and used daily by more than 1000 financial institutions. With the PSD mandating shorter clearing timelines for credit transfers, it is even more relevant to carefully select the right messaging provider not only from a price perspective but also from a reputational and service level viewpoint. In addition, a recent revamp of the pricing principles makes this choice even more attractive for individual institutions and communities alike.

Take away #5: carefully select an efficient messaging provider that supports your long term needs, has a track record of excellence, and has a commitment to serve the financial industry going forward.

Despite the urgency, take a step back and take some time to reflect on the “raison d’être” of the clearing activity of your institution. The answer may not always be “do the same as today tomorrow but differently”. There’s a need to consider more creative solutions, including potentially outsourcing all or part

of the clearing activity. This can of course be declined across business lines and across geographies.

Take away #6: make sure the journey is worth embarking on for you before you set out.

Payments clearing is a game of scale. Unless you are turning profits from a true niche market (in terms of geography or customer base) and this is likely to remain the case over time, there is little you can do against an industry “mammoth”. The processing costs are pretty fixed and not linear alongside volumes, and marginal costs per unit will eventually make the business difficult to retain. The options are therefore to lose the business for good or outsource the processing while keeping the customer-facing business and global relationship.

The SEPA heat map can help the decision-making process. Once filled in according to your profile with the snapshot from the “as is” to the “to be” situations, it is easier to associate the project costs for each sub-project and get a clear view of the work ahead.

The decision-making process can then really begin, crossing out unrealistic objectives, favouring other innovative solutions and making sure that the whole picture looks consistent against the clearing strategy of your institution.

Form your own opinion

Although situations differ per country and institution, the question still remains, “Why should we invest so much in something that offers no proven enhancement to processes/operating cost and where the

value proposition to customers is still not clear?”

From the “as is” situation and the “weather forecast”, and taking into account the end point of the journey, it may happen that the effort, time or resources are missing. From the heat map it may already become apparent that some activities are disproportionately priced in relation to the expected benefits of maintaining them. Others may well be over the top in their running costs or investment levels or return on investment, while cheaper more flexible solutions may well be on offer from peers/competitors or third-party service providers outside.

There are sometimes drastic choices to be made and trying to recreate the situation of the past at any cost is not always the best way forward, especially in times of scarcity.

Take away #7: decide what is reasonably/strategically/economically feasible for your institution: be realistic and don’t overstretch.

Building on the heat map, the roadmap adds an extra dimension. You can retain in-house projects and position them as regards priorities and interdependencies if any, while identifying and assessing outsourcing avenues for other sectors (e.g. SDD e-mandates). From there, you need to carry out close follow-up of projects, make adjustments along the way and make a regular “mark to market” of next steps as regards the evolving landscape. This may as well require some more technical-related skills to be mobilised in-house or externally.

Conclusion

Nobody ever said the path to SEPA would be smooth. There will be winners and losers along the way. Some of you already have your itinerary and will be doing your best to stick to it, while others still need to plan your journey.

Regulatory action has been expected for some time and that day has now come. The regulators are pressing ahead with the end-dates and with the imposition of the related obligations that they entail, both directly and indirectly. There is therefore now no other choice than to go for compliance. The question remains how, for what and whether it is worth going there for each and every institution.

The steps set out above give a high level overview of what needs to be considered in order to make sound decisions going forward. These steps are certainly valid for institutions that are still undecided as to what they are going to do about SEPA, but they may also serve as a useful extra checklist for those that have already kicked off their project and are moving ahead.

In times of scarcity, and in order to ensure that decisions are taken on the right footing, it is more important than ever to rely upon strong partners to forge an assessment of your situation and derive your decisions, all the way from strategic to operational, based on sound factual information and a clear and realistic ambition for the future.

If you found this white paper useful, you might be interested to know that SWIFT offers a wide array of consulting services ranging from technical assessments (e.g. STP analysis) to a full review of the organisation of your payments back office/s and best practice sharing, up to business and strategic consulting services leveraging our unique expertise in payments clearing and market analysis.

Please do not hesitate to contact us with any questions and we hope that our accumulated expertise can contribute to the shaping, refinement or execution of your payment strategies.

- [1] "Will the SEPA End Date really change the game?", SWIFT SCRL, 2011 http://www.swift.com/news/press_releases/sepa_white_paper
- [2] "SEPA Redux, Understanding How We Got Here" and "The SEPA Ripple Effect: Impacting a Non-European Country Near You Soon", Celent, 2011.
- [3] "SEPA pumps up the volume", Capco, 2011
- [4] VocaLink website:<http://www.vocalink.com/press-room/press-releases-2011/vocalink-announces-new-global-strategy-and-a-phased-withdrawal-of-its-sepa-services-.aspx>

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