Yves Mersch: Strengthening the European financial industry amid disruptive global challenges

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the European Institute of Financial Regulation (EIFR), Paris, 3 September 2018.

* * *

Europe's financial industry still faces a number of challenges. Its continued weak performance, with low price-to-book ratios and meagre profitability, is ample proof of that.

Some of those challenges – such as high levels of legacy assets, the need for deleveraging and the burden of stricter regulation – are a result of the financial crisis. But even before the financial crisis, the industry was facing pressure on various fronts, and those challenges are still there. In particular, fundamental technological change continues to call established business models into question.

Today, I will focus on disruptive challenges that are arising in a particular area of business: digital technology. Such technology is becoming ever more important in banking and is opening the door to competition from non-banks in core areas such as payments. Cascades of complementary innovations have already fundamentally altered the payment landscape, and European banks need to act now if they want to avoid losing out to bigger international players.

The euro area has been very successful in providing a top-tier foundation for innovative payment services. However, this foundation has not yet been fully utilised by European players to provide true statelof-the-art pan-European services. There is currently a window of opportunity for Europe's financial industry to make use of this top-tier infrastructure and the changing patterns in retail payments. But in order to seize these opportunities, it needs to avoid the mistakes of the past.

Laying the foundations

The euro was introduced in 1999, with physical banknotes and coins following in 2002. However, that success was not matched by integration in the market for electronic retail payments in euro, with national solutions remaining disparate and lacking interoperability. While the establishment of TARGET, the real-time gross settlement system for the euro, resulted in a fully integrated money market and wholesale payment market, cross-border retail payments in euro remained expensive, slow and inefficient, with no standardised way of making electronic payments across the euro area. For far too long, huge economies of scale remained unexploited.

The ECB played a key role in laying the foundations for such standardised cross-border payments through the establishment of the Single Euro Payments Area (SEPA) – an endeavour that required substantial efforts by all stakeholders. That initiative consisted of two key stages.

First of all, a harmonised legal framework was needed for payment services in the EU. Thus, the Payment Services Directive (PSD) was adopted in 2007 and entered into force in 2009.

Second, it was important to ensure that consumers and businesses in the EU could send payments to each other quickly and easily across borders, with no differences between domestic and non-domestic payments. The SEPA credit transfer and SEPA direct debit schemes replaced all domestic payment schemes in the euro area, using fully interoperable global standards.

Catering for innovation

In the current age of rapid technological progress, it is vital to ensure that innovation delivered by banks and non-banks reaches all European citizens. Innovative bespoke national solutions using national – or, more frequently, non-European – technology could threaten the integration achieved by the various SEPA schemes.

Innovation may start at domestic level, but it should not face barriers preventing pan-European expansion. Thus, national solutions should provide for pan-European reach in their initial design. As these solutions tend to be provided by non-banks or disseminated by local banks on behalf of non-European entities, third-party providers need regulated access to payment accounts. The revised Payment Services Directive (PSD2), which is currently in the process of being implemented, will provide secure and interoperable payment account access and will allow innovative new payment services to be provided in the EU. What we don't need is integration with non-European countries that runs counter to European standards.

While legislation is indispensable for an integrated market and to promote innovation, it is not the only precondition. Cooperation between stakeholders is also essential in order to ensure smooth and harmonised processes throughout the EU.

The ECB has brought the market together, initially via the SEPA Council and then via the Euro Retail Payments Board (ERPB). The ERPB was instrumental in the development of the SEPA instant credit transfer scheme, which is now live, with over 1,000 providers participating. Those instant payments have been achieved without legislation, with the ECB instead facilitating dialogue and consensus between market actors.

Moreover, that scheme will soon be complemented by the ECB's new Target Instant Payment Settlement service, which is set to go live this November, providing a real-time, high-end platform for payment service innovation.

The challenge for Europe

Progress towards an integrated market for payments has not been without its problems. Europe still does not have an integrated, standardised card payment network, with the vision of being able to use any card at any payment terminal in Europe having yet to be realised.

Europe's largest card payment networks are still not interoperable. For example, Germany's Girocard and France's Cartes Bancaires account for a substantial number of card payments in the euro area's two largest economies. However, owing to significant technical differences, a supposed lack of a business case and an absence of political will, these two networks remain separate – as do most other national card schemes. As a consequence, it is more convenient to use non-European cards when travelling across Europe.

Although some standardisation work has been carried out via the European Cards Stakeholders Group, Europe still does not have its own Europe-wide card scheme, so we remain fully reliant on non-European schemes when making cross-border card payments. Although they provide a valued service, those schemes raise certain questions from a governance perspective. European banks have relinquished their influence in this area, possibly because of short-term profit considerations.

Indeed, large non-European companies now play a significant role in the provision of payment services in Europe, while European banks are focused solely on serving their national markets.

Let's face it: the foundations laid by European institutions have not been leveraged by European providers in order to offer panIEuropean services. Instead, those foundations are often exploited by multinationals from outside Europe offering innovative, consumer-friendly solutions. Indeed, European banks seem to have surrendered much of the panIEuropean payment business.

PayPal now dominates the market for online payments in Europe, using the pan-European SEPA credit transfer and SEPA direct debit schemes to provide harmonised services. Meanwhile, Google, Apple, Facebook and Amazon – often referred to collectively as “GAFA” – are also offering significant payment services with pan-European reach, some of which involve joint ventures with individual banks at national level. At the same time, Chinese giants like Alibaba and Tencent are advancing. While these companies are to be admired for their ability to expand and provide innovative services that consumers want, I would ask why there are no European companies competing in that arena.

There is a risk that our dependence on foreign providers will increase further as regards the development of innovative payment services, since banks are resisting the objectives of PSD2 on this front. They have been defensive when it comes to granting technical access to new and innovative payment service providers, which will limit European fintech companies’ ability to provide competitive solutions. Indeed, I fear that global giants from outside Europe will use their network power to increase their presence further.

In other sectors, European companies have succeeded in achieving global reach. In the car industry, for example, European vehicles set the standard when it comes to quality and reliability. There is no reason why this success cannot be replicated in the area of payment services – or financial services in general.

The way we pay in Europe is changing. Significant numbers of consumers are moving to online payment channels, with retail payments increasingly being carried out via mobile phones. At the same time, virtual currencies have long been a topic of debate – and not only among experts, either.

European citizens demand pan-European services that are safe and efficient. Consequently, there is a need to look carefully at the governance and regulation of payment solutions. Many payment channels are provided by non-European companies. Although those companies comply with our legislation and use our payment infrastructure, they are, for the most part, not domiciled in Europe. This increases our dependence on third countries. In particular, we have to be mindful of the fact that extraterritorial jurisdiction could, in a worstlcase scenario, affect the operation of those companies and disrupt payments between European counterparties. In the current geopolitical environment, such risks are, unfortunately, not as remote as they once were and need to be taken seriously by European policymakers.

Conclusions

We have laid the groundwork by providing safe and efficient market infrastructure, and this should be used as a basis for innovative, user-friendly solutions. The way to protect the integrity of European payment services is not by closing them off to the world, but by making them global players. Building on local or national solutions is anachronistic and will not meet the needs of the market.

If we are to succeed at a global level, the issue of domestic governance needs to be addressed. Our reliance on non-European card schemes for domestic payments in Europe is suboptimal. European card schemes should make interoperability and full pan-European reach their main priorities, enabling any card to be used at any terminal. At the same time, governance arrangements need to cater for European needs, given that cards are the single most important electronic payment instrument in Europe.

However, protectionism should not be used to artificially promote European innovation in payment services. We should remain open to global players, but should focus more on addressing the reasons for the lack of major European providers in the payment market.

It is important that European payment service providers are active at a global level. Rather than establishing national solutions, we should seek to develop global solutions based on European open governance that use European infrastructure.

Europe boasts state-of-the-art payment systems. They should be used by pan-European providers to offer innovative, safe and user-friendly solutions for the benefit of people across Europe and all over the world.