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Governance, efficiency and integration in retail payments

Ladies and Gentlemen,

It is an honour that a Hungarian central banker has been invited to represent the out EU countries in this panel. Maybe I will not make a big mistake if I assume that this is somehow linked to the fact the Hungary is the President of the EU Council in the first half of 2011. I will focus on three 3 major topics: governance, efficiency and integration. I will speak primarily about Hungarian aspects, and I would like to show you that most of Hungarian aspects are closely linked to the European issues.

Governance

I will take a bird's eye view first. In my view in a network market such as that of payments, public authorities clearly have a responsibility in fostering the public good. We should not be shy even if this can be achieved only via regulation.

Governance mechanisms that integrate all stakeholders are very important. In lack of this, central bank or other public policy intervention is warranted.

It is very important to find the proper governance model to steer the retail payments market at domestic level. In most countries, including Hungary as well, central banks and banking communities set up payments councils or other special fora discussing payments related issues. In ideal case these fora should consist of representatives of market participants (both supply and demand sides, i.e. payment service providers and payment service users), and regulators.

The involvement of payment service users is more difficult than the involvement of the payment service providers as the variety of users is significantly wider than that of payment service providers. Consumers, retailers, businesses/corporates, small and medium-sized companies and national public administrations belong mostly to payment service users. We have to notice however, that the groups of payment service users are not homogenous and there is usually no single association for payment service users.

Therefore central banks have a key role in the governance of payments related issues. They should support the interest of customers, and act in accordance with the interest of the entire society and public good. Central banks should act for social efficiency and should not be captive of short term banking community interests. I mention this because during our presidency work sometimes we have the impression that some central banks represent rather the short term interests of their banking communities and not those of end-users.

Central banks should bring policy aspects in decision-making since market mechanisms alone may not be enough to achieve the maximum public welfare. In extreme cases it may be necessary that central banks like 'benevolent dictators' advocate and enforce the public good either through moral persuasion or legally binding regulation. In order to be able to serve public good central banks should be simultaneously initiators, coordinators, catalysts, regulators and inspectors, or that they sit in the driving seat.

Having said that I would like to emphasize that we should not behave like a bull in a china-shop, like regulators sometimes do. Thus the functioning of market forces should not be restricted unless it is directly required by the interest of the public good.

SEPA process is a good example of why in some cases self-regulation may not be enough due to short term business interest of intermediaries.

Taking a historical overview we can conclude, that the European Payment Council was able to produce high quality standards and recommendations for a number of payment instruments, e.g. SEPA credit transfers, SEPA direct debits, and cards over its 9-year history.

The SEPA credit transfer was launched without direct involvement of regulators in January 2008, but for the launch of the SEPA direct debits joint statement had been required by the European Commission and the European Central Bank specifically flagging the long term use of multilateral interchange fees. Given the slow migration to SEPA credit transfers and direct debit, and failed self-regulation on end dates, the legislator has been invited again, this time, to adopt a legally binding regulation on end date(s) for credit transfers and direct debits.

The Commission elaborated a proposal for the regulation by the end of 2010. In cooperation with the European institutions and Member States, Hungarian Presidency is working hard on finding compromise in relation to the proposal for the regulation. The Hungarian Presidency takes fostering the migration very seriously and acts on the matter in the spirit of European responsibility. Hopefully general approach can be reached in the Council by the end of June, and then the work can be followed in the context of trialogue during the forthcoming Polish Presidency.

We had a déjà vu when we saw the Hungarian discussions on an intraday clearing project because virtually there were the same developments that have happened in the SEPA process. Hungarian banks supported intraday clearing from a technical point of view but not from a business point of view. They asked for regulation but did not like what they got in the end.

5 years ago the MNB proposed to the banking community that the current T+1 clearing should be shortened, made intraday and based on the new European (SEPA) standards. The main motivating factors included (i) a clear demand from corporates for faster (close to real time) retail clearing, (ii) unsuitability of real time gross settlement transactions for retail payments), (iii) reduced competition among banks due to the widely used intrabank (on-us) transactions, which are settled in real time and are based on banking practice of corporates keeping accounts with a number of banks, including mostly some big banks. We have prepared studies on liquidity management changes, costs etc. but the Hungarian banking community was reluctant to launch the intraday clearing project during the most of a 5-year period devoted to the preparation of the project.

Banks were quite happy with t+1 clearing, as they could enjoy a one- (business) day float. They raised doubts about the effective demand of customers. They indicated shortage of funds for adapting their systems to the outcome of the project by saying that it would not generate competitive advantages for themselves. SEPA migration was in principle welcome, but not immediately, only in “due course”, i.e. in case of a close and realistic target date for the adoption of the euro. Some banks advocated a central bank regulation for guaranteeing strict enforcement of a go-live date. With all documents, plans, cost analyses, and detailed specifications ready, the decision on actual start of implementation has been postponed several times.

Amid conflict of interests of individual banks and the reluctance of banking community to make decision on actual start of implementation, the Hungarian central bank has decided to use its regulatory power, as the timely implementation of the project was in the interest of the entire society and the public good through the elimination of the float on banks’ side and improvement in the quality of services provided to customers.

The Hungarian central bank has regulated rather the intraday clearing side than the SEPA side of the project, requiring to credit the payees’ bank within at most 4 hours starting from the receipt of the payment orders from payers. This rule will enter into force as of 1 July 2012, which becomes, in accordance with the decision of the Hungarian payment council, the deadline for the implementation of the Hungarian intraday clearing project.

Is there a happy end? Yes, there is. Together with banks and Giro, we are working hard to make the project to come through. Seen retrospectively, there are a number of banks who are now already happy about the actual start of the project and thus they share with us the same vision towards a more integrated and efficient retail payments market. A mixture of talks, technological innovation, standardisation, self-regulation and legally binding regulation has been used, and in addition to this mixture we closely monitor the implementation of project and in due time, i.e. after the go-live date: 1 July 2012 we will control the compliance with the regulation.

Efficiency

Going to the second topic of efficiency let me start with a very popular research topic of the past years.

In the last couple of years it is in fashion that central bankers publish so called cost of payments studies. One may raise the question whether it is a good or bad fashion. I definitely belong to that group of supporters, who perceive cost of payments surveys as a very important form of communication to policy-makers and strong underpinning why public welfare can warrant public policy intervention in these markets.

In a free market economy, one has to prove – and not just say – that on the one hand the social costs of cash are higher than that of electronic payment instruments and on the other hand, the market alone – due to the strong externalities that exist in this field – cannot achieve social optimum.

The Hungarian central bank has therefore joined the pan-European survey on social costs of retail payment instruments. We have prepared our own analysis on the costs of Hungarian retail payment instruments. We have done it, because the use of cash is excessive in Hungary in comparison with other European countries. The value of cash in circulation corresponds to about 8% of GDP in Hungary, and partly we face the implications of the hidden economy. We need systematically collected and processed information on the use of various retail payment instruments and the related costs along the payment chain, to underpin our policy decisions. We wanted to be convinced of the lower social costs of electronic payments in relation to that of paper- or cash based ones.

At the same time we have overhauled the payment habits of the Hungarian public sector, and indentified the most in-effective areas in their payment habits. Our key motivation was that payments by and from public sector account for about 30% of retail payments in Hungary.

We have taken a snapshot of the payment habits of Hungarian households, and we have prepared a geographical and time map of the Hungarian payment transactions and the underlying infrastructure (availability and location of ATM-s, POS terminals, branch offices, etc.). In cooperation with the Hungarian Competition Authority we have analysed the current size of interchange fees applicable for domestic card transactions and the pros and cons of intervening into the functioning of this market.

Let me shed some light on the summarised outcome of the above-mentioned studies and main conclusions we have drawn for the future.

The costs of payment transactions are too high. The annual social costs amount to EUR billion 1.38 (or 1,5% of the GDP), and almost 2/3 of these costs relate to cash transactions or cash intensive postal transactions (postal inpayment money orders for utility bills and postal outpayment money orders for pensions). In contrast with the electronic payments, cash transactions and cash intensive postal transactions are characterised by relatively high variable cost shares, and consequently the cost of an additional payment transaction is higher than in case of electronic payment instruments. At certain breakeven points the electronic payments will become less expensive than cash transactions and cash intensive postal transactions. Consequently cost savings can be achieved exclusively through changes in payment habits.

Annually about 380 million euro (or 0.41% of the current GDP) could be saved in Hungary if the payment habits changed. We assumed a situation with no change in the combined number of transactions, but a payment pattern very different from the currently used one i.e. a vigorous increase in the number of electronic credit transfers, direct debits, and debit card transactions. The potential saving is large enough not to wait until the organic evolution alone will produce results and thus it encourages us to make a trial for accelerating the process of changes and influencing the selection of payment instruments by users.

Each third payment from or to the Hungarian public sector is currently based on the use of cash. In value terms the cash based payments of the public sector corresponds to 17% of the Hungarian GDP. Thus the public sector does not show a positive example in the use of efficient payment instruments, what is prominently characteristic for the about 3000 local governments (both on the incoming and outgoing payments), as they use very heavily cash. This statement is also valid for the central government with respect to outgoing payments. About 51% of the pensions are paid in cash via the post offices. Moreover the liquidity and account management are decentralised in the sector of local governments.

About 89% of households has at least 1 payment account, and about 85% of households has at least 1 payment card, but households still use cash mostly. The low usage rate of electronic payments is explained by the continued existence of traditional payment habits, lack of information, motivation and partly confidence. It may also happen that even in case of willingness to pay electronically, the lack of infrastructure hinders the use of payment cards. The infrastructure is still underdeveloped; the spread of POS terminals is currently governed mostly by tourism in the countryside, while the branch offices of credit institutions concentrate clearly on larger settlements.

The interchange fees account for about 0.5% of the payment card transaction value what seems to be higher than the limits undertaken by the 2 main international card companies (MasterCard and VISA) who dominate the Hungarian market.

Both the use of non-cash instruments and the spread of POS terminals have been constantly growing, nonetheless the growth rate is less than desired, and it would take at least 10-15 years before we could reach the present status of the Nordic countries.

Based on the results of the cost study and aimed at enhancing social benefits, the Hungarian central bank has started a more active communication, as a neutral position would not facilitate the fast realisation of cost savings. In our view, all stakeholders should seek together the ways to influence payment habits and thus intervene into the individual decision–making on the choice of payment instruments. The Hungarian central bank has therefore launched a social dialogue. The very first step in this direction has been a recent domestic conference held on the presence and future of the domestic payment industry, where we presented the results of the studies and ideas for influencing payment habits. I am convinced that much better is for the whole economy if the responsible authorities first measure, then analyse and thereafter regulate. Unfortunately we see a lot of examples when regulation happens first without any measurement and analyses which leads to disturbances.

Before outlining some possible measures aiming at influencing Hungarian payment habits, let me draw a parallel between the Hungarian and European developments. Neither the Hungarian public sector, nor a very large number of European public administrations lead the process towards a more progressive payment pattern and SEPA migration respectively. We know from the recent communication of the European Commission, that the share of SEPA credit transfers out of all credit transfers undertaken by public administration is below 10% e.g. in the Netherlands, Italy, Germany and France.

Therefore we can say, that public authorities' behaviour in the payments market can be in sharp contrast to what their public policy intentions and communication are. Public authorities should start change with themselves.

Returning to Hungarian fields we see vast opportunities in the reduction of cash usage in public sector. To the reasonably greatest extent all government outflows (pensions, social benefits) should be made to payment accounts. We consider the better involvement and wider electronisation of the network of the Post offices in order to improve the access to payment services. The extension of the POS network might be supported. Ensuring government control above the interchange fees is being further analysed. Sharing the fees between payers and payees for the widely used postal instrument is also an option, but we might achieve it through a more transparent pricing of the underlying services, such as electricity, gas, water bills, insurance premia, etc.

We would like to investigate the feasibility of the establishment of an EBPP scheme which covers the entire Hungarian banking system and which is open to each service provider (public utilities, insurance companies, etc.) and any consumers. This is again an area which is closely linked to the European developments.

Integration

I have asked my magic ball about the issue and it answered me that we still have a long way to go to achieve full integration and a single market but in case of lucky constellation of stars the process may accelerate. Credit transfers and direct debits are far from constituting the full payments market. Cards and e-products are the future and we have a responsibility not to allow fragmentation in those segments of the single market.

Cross-border integration is very important and is in the direct interest of payment service users, especially in a small open economy.

In case of certain banks, cross-border optimalisation is the driving force behind the transformation process. This holds particularly true for Hungary, as most of the Hungarian banks are either subsidiaries or branches of multinational groups, and they aim at profitability at a group level. It goes without saying that cross-border optimalisation and the underlying economies of scale are more feasible when the same standards and the same currency are used across the region where the group is engaged in activities.

The efficiency of cross-border transactions is of great importance for each open economy irrespectively of being a small or a big country, a euro area or a non euro area country. The importance of regional requirements is increasing steadily in line with the implementation of SEPA.

To achieve a truly single market it is of utmost importance that European or broader standards are developed and used already at the start-up phase of innovative e-payments products, so that innovation become truly European and not only national. The responsibility of European authorities and central banks is to create an environment that ensures this.

We have to prevent from causing a fragmentation of e-payments, because there is a stressing demand at each national market where such scheme has not yet been available to come up with something. It would save lot of resources for each concerned country if they could resort to a truly European scheme.

It is very important that any type of national or European regulation (e.g. the SEPA end date regulation) do not hamper innovation by rules carved into stone and integration by country-specific waivers and niche products.

Finally I would like to touch upon the issue of payment infrastructures. At the outset of the euro era it was expected that the fragmentation of retail payment markets would be abolished. Some national clearing houses have merged, some pan-European clearing houses have emerged, but still national clearing houses are the dominant institutions in this field in most of the Members States. I am convinced that the use of SEPA standards and achieving interoperability will increase the competition between the clearing houses and thus accelerate the process of consolidation which will lead to economies of scale. But if we achieve this we might face a duopoly or monopoly situation, and a new task will emerge how to handle the pricing by the winners in such a new environment.

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Let me conclude. I am convinced that when European and national institutions take up the tasks that are ahead of them then we will have better integrated and more efficient European retail payment market. This is of utmost importance as we understand the significance of the public sentiment. As Abraham Lincoln said in a speech delivered at Bloomington on 26 September 1854: “With public sentiment, nothing can fail; without it nothing can succeed.”