

Will instant payment replace cash?

Rémi Steiner

Ingénieur général des Mines, Financial services adviser to the General Economic Council

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Abstract:

Payment services in the United Kingdom have undergone a thoroughgoing change. British consumers and firms were resigned to antiquated, second-rate payment services, and to waiting at least three days for a payment to be executed. Over the past decade, they have become accustomed to nearly instant bank transfers and to a burgeoning offer of new services. Meanwhile, the payment industry in the euro area was busy meeting the objective of removing national borders, which impeded transactions. Starting on 1 August 2014, a bank transfer or debit is executed under the same conditions regardless of whether both originator and beneficiary are in France or whether one is in another euro area country. Today, although lagging behind the UK, instant payment could, as early as November 2017, upend habits and entrenched positions.

Instant payment has been operational in the UK since 2008

In the early 2000s, the British government made sweeping changes in how its retail payments market was organised. The Cruickshank report¹ pointed out a series of weaknesses, including excessive banking concentration, poor service quality and indulgence on the part of the authorities: "The market for money transmission systems needs radical reform. It requires continuous scrutiny via a licensing system supervised by an independent payment systems commission."

Starting in March 2004, the Payment Systems Task Force, led by the Office of Fair Trading (the UK's consumer protection body between 1973 and 2014), was asked to examine competition and efficiency issues with respect to payment systems. The task force, with representatives from a broad range of sectors, concluded its work in February 2007 with the publication of its final report², and handed off to a standing body, the Payments Industry Association.

⁽¹⁾ "Competition in UK banking, a report to the Chancellor of the Exchequer", Sir Donald Cruickshank, March 2000.

⁽²⁾ "Final report of the Payment Systems Task Force", Jonathan May, February 2007.

From the outset, the need for a faster clearing service was identified. However, "faster clearing" meant "same day" for order payments made early in the morning, and "next day" for order payments made later in the day. At the time, the minimum clearing period for order payments was three days; not making the funds available immediately was one way for the banks to pay themselves back. Consumers' and businesses' somewhat cautious responses to these concepts were tested under different cost scenarios: the banks estimated that it would take two years to implement, at a cost of £65 million. On 24 May 2005, the Faster Payments project was agreed in principle.

Additional efforts, under the auspices of the Association for Payment Clearing Services (APACS), led to the definition of specifications for a new payment platform capable of enabling nearly instant payments. On 16 December 2005, the infrastructure for a faster payment system was entrusted to a joint venture between Voca and LINK. Voca was the new name given to BACS Ltd, the operator that cleared UK retail payment systems, and Link was responsible for the real-time IT management of ATMs. The two companies merged in July 2007 under the name VocaLink.

The Faster Payments Service (FPS) was launched on 27 May 2008. It enabled payment transactions to be carried out in a matter of seconds between two participating direct banks (out of a dozen), 24 hours a day, 7 days a week. FPS is a net settlement system: the mutual commitments of the participating banks are cleared, secured by central bank deposits and settled several times each day.

At first, growth was relatively slow because the offer of instant payments outpaced customer expectations and because the banks did not take a concerted approach (maximum amounts, anti-fraud mechanism, etc.). Initial uses concerned short-term loans, wage settlements and payment of suppliers "at the delivery door". Now, individuals account for the largest share of instant payments: sharing costs with friends, account-to-account transfers and so on.

By January 2017, 7 billion instant payments had been processed since the introduction of FPS. In 2016, the service processed 1.43 billion transactions, of which 882 million were single immediate payments (as opposed to recurring or deferred payment orders). By comparison, that same year saw 2.15 billion traditional transfers (BACS direct credit) and 356 million cheques.

Between 2009 and 2016, the volume of instant payments grew at an average annual rate of 25%, while the number of cheques fell off at an average annual rate of 12%. Beginning in 2012, a requirement to credit the beneficiary of a payment transaction no later than the day after the debiting of the account of the originator of the transaction boosted the migration of payments over to FPS.

Since March 2016, the New Access Model program has allowed FinTech vendors to settle their payment transactions directly via FPS, i.e. without the need to go through a participating bank. TransferWise, the low-cost solution for international transfers, is interfaced with Faster Payments.

The increasing volume of transactions is fuelled by the emergence of innovative payment applications:

- Paym, which debuted in April 2014, connects a bank account with a mobile phone number to facilitate person-to-person payments: more than 3 million users have signed up, and more than 2 million payments were made using Paym in the first half of 2016;
- A new growth driver for instant payment is the Pay by Bank app. Developed by VocaLink, it is supported by major merchants and banks. Pay by Bank facilitates payment on e-commerce sites and at traditional points of sale: a Pay by Bank icon links the customer to his or her bank's website, where, in a familiar setting, he or she can validate the instant payment.

The ECB's goal is to foster deployment of instant payment across the euro area as from November 2017

FPS has proved that an instant payment system is relatively easy to deploy, and it is a springboard for the modernisation of the payments market, which in turn serves the entire economy. In Europe, Sweden, Poland and Denmark have also introduced instant payment systems: in 2012 for Sweden and Poland (the Swedish app Swish, which uses the BiR platform, and the Polish Express ELIXIR and BlueCash systems), and in 2014 for Denmark (express transfers).³

At the same time as the UK was setting up FPS, a pan-European payment infrastructure for low-value payments was being developed and deployed with the goal of "making the concept of the euro area as a 'domestic payment area' tangible and transparently clear to citizens". This was the SEPA (Single Euro Payment Area) project. On 1 August 2014, transfers and direct debits based on national specifications were abandoned in favour of SEPA Credit Transfer and SEPA Direct Debit.

However, the lengthy and complex implementation of this project has not allowed the euro area to acquire the most modern payment infrastructures, opening the door to the risk that arduously-achieved integration will be undermined by the emergence of instant payment solutions in some euro area countries. The European Central Bank has decided to take the lead, given that instant payment also serves to reduce counterparty risks between financial institutions.

In a statement released on 1 December 2014, the Euro Retail Payments Board (ERPB), which brings together representatives of both payment service providers and consumers under the chairmanship of the European Central Bank, believed that instant payment represented an upcoming challenge for the financial services industry, and that it was important to consolidate the euro area integration already achieved with the SEPA project.

⁽³⁾ See "Pan-European instant payments in euro: definition, vision and way forward", European Central Bank, 12 November 2014.

The statement defined "instant payments" as "electronic retail payment solutions available 24/7/365 and resulting in the immediate or close-to-immediate interbank clearing of the transaction and crediting of the payee's account with confirmation to the payer (within seconds of payment initiation). This is irrespective of the underlying payment instrument used (credit transfer, direct debit or payment card) and of the underlying arrangements for clearing (whether bilateral interbank clearing or clearing via infrastructures) and settlement (e.g. with guarantees or in real time) that make this possible."

One of the special features of an instant payment system, in comparison to traditional payment systems, is the need for a messaging system: the beneficiary's financial institution must immediately inform the originator's financial institution of its ability to accept payment, and both the beneficiary and the originator must be immediately notified of the execution of the payment.

Another particularity is that a beneficiary's account can be irreversibly credited even before its financial intermediary has itself been credited with the corresponding funds. The balance of transactions between financial intermediaries should be calculated on a continual basis, but netting differences are not necessarily settled in real time between those intermediaries. As a result, financial institutions must constantly manage counterparty risks that arise between them as a result of instant payment transactions between them carried out by their customers.

The ERPB validated the approach proposed by financial institutions, represented by the European Payment Council (EPC). An EPC document from November 2015 proposes guidelines for "SCT Inst", a euro-denominated instant payment scheme based on the SEPA credit transfer and specifying the full set of shared standards likely to be applied at intermediate stages, between the launch of an instant payment and the associated clearing/settlement transactions (with these end stages remaining at the discretion of SCT Inst participants).

The cost of implementing instant payment is likely to vary widely from one Member State to the next, and from one financial institution to another, depending on their current infrastructures. It was agreed that the scheme would be optional: each financial institution would be free to take part in the instant payment launch, but it would not be required to do so. A participating institution has a minimum commitment to allow its customers to accept instant payments, but not necessarily to allow them to issue such payments. A critical mass of participating banks may not be reached until 2020.

The SCP Inst Scheme Rulebook, which contains implementation guidelines and an appendix on risk management, was published on 30 November 2016 on the EPC website, with a view to implementing the scheme in November 2017. Initially, instant payments will be limited to €15,000. The target maximum execution time is set at ten seconds between the receipt of a payment order by the originator's bank and its receipt of the confirmation by the beneficiary's bank of the regularity of the order.

The ECB has also made clear its expectations of clearing and settlement platforms: the goal is to take a pan-European approach to instant payment through appropriate rules on openness, interoperability and risk management.⁴ A payment service provider must be able to reach any other payment service provider within the EU. The infrastructures concerned must allow for the implementation of instant payment under sound interoperability conditions by November 2017.

On 22 June 2017, the ECB itself announced the launch in November 2017 of a new service, Target Instant Payment Settlement (TIPS), which will enable euro area banks to exchange small-value transfers between themselves instantly and at any moment. This service is designed to facilitate the rollout of instant payment to bank customers throughout the euro area (at a price of €0.002 per payment, at least for the first two years of operation).

Deployment of instant payment could disrupt the retail payments market

Neither consumers nor businesses have expressed a strong need for instant payment. This is similar to what happened in the UK in 2005, where studies prior to the launch of instant payment showed that banking customers were tolerant of processing times and found it difficult to picture the changes that would result from shorter ones. The UK's embrace of instant payment has been gradual, and payments made via PFS are still in the minority.

Nevertheless, it is tempting to believe that, as in the UK, the shift in euro area countries towards instant payment will be a powerful incentive to transform their payment services, especially if government involvement and guidance can ensure the universality, interoperability and security of transactions. A more efficient retail payment system could well have an impact on the economy as a whole, stimulate e-commerce and foster competition between banking and non-banking institutions.

The ECB's initiative is also in line with the entry into force of the 2nd European Payment Services Directive⁵ in January 2018, which will create two new categories of regulated institutions: Account Information Service Providers (AISPs) (also known as "account aggregators") and Payment Initiation Service Providers (PISPs). These new stakeholders will be able to offer their customers, without the banks being able to oppose it, consolidated information on all their bank accounts and the possibility of initiating payments by debiting any bank account opened in a third institution.

From the banks' point of view, any business plan based on instant payment invoicing is not written in stone, as the interest of consumers and the price they would be willing to pay for this step forward are unknown. In addition to benefits in terms of image and range of services, there may be gains – as in the UK – from gradually replacing cheques and cash transactions by instant transfers. However, instant payments can also compete with credit cards, which are the main source of profitability for banks in the area of payments.

⁽⁴⁾ In this regard, see the November 2016 report by the Bank for International Settlements' Committee on Payments and Markets Infrastructures entitled, "Fast payments – Enhancing the speed and availability of retail payments".

⁽⁵⁾ Directive (EU) 2015/2366 of 25 November 2015 on payment services in the internal market.

Technically speaking, keeping customers' accounts in real time rather than on a daily basis represents a major technical and commercial challenge for some institutions. Availability of service 24/7 is another difficult objective. These advances for banks could bridge part of the gap between them and the FinTechs, which now present real-time account management as an advantage to their customer base. But while instant payment could put the innovative offers by new entrants into perspective, it is also likely to encourage the emergence and success of any new application, both inside and outside large banks, such as Paym, Pay by Bank or TransferWise in the UK.

Although there is no reason to believe that instant payment is any less secure than any other form of payment, it seems likely that it will facilitate the execution of fraud schemes (social engineering, phishing, etc.), by allowing the immediate distribution and transfer of ill-gotten gains outside the reach of the police and the courts. Instant payment thus obliges governments and banks to rethink their anti-fraud and AML/CFT systems, with a view to anticipating suspicious transaction patterns and monitoring them in real time.

In a consolidating European market, clearing and settlement infrastructures face a major challenge and new opportunities as a result of instant payment. This is particularly the case for STET, a joint subsidiary of the major French banks, and EBA Clearing, a subsidiary of 53 European banks (including key French banks).

The cases of instant payment use most likely to encourage rapid dissemination appear to be smartphone-based peer-to-peer payments, as well as payments between consumers and merchants. In the latter case, instant payment offers merchants an attractive alternative to credit cards. Which is preferable: for the merchant to accept a payment by card and thus benefit from a payment guarantee (face-to-face or remotely, with a strong, 3DSecure-type authentication system) or to accept an instant payment that confirms that his account has been credited before he even divests himself of the item sold?

The development of instant payment could thus enable European economies to become less dependent on card payment systems and the American Visa/MasterCard duopoly, a dependency that raises issues of sovereignty. MasterCard's acquisition of the British firm VocaLink (finalised on 2 May 2017) reveals the importance of this issue!